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Andreas Fischer	Inflation Targeting: The New Zealand and Canadian Cases
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Paul E. Godek	Bad Policy, Bad Law, and the Constitution: A Stiglerian View
Gary M. Anderson and Robert D. Tollison	Barristers and Barriers: Sir Edward Coke and the Regulation of Trade
Jonas Frycklund	Private Mail in Sweden
Emily Chamlee	Indigenous African Institutions and Economic Development
Herbert J. Walberg and Joseph L. Bast	School Choice: The Essential Reform

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CATO JOURNAL • VOLUME 13 NUMBER 1 • SPRING/SUMMER 1993

ARTICLES

Andreas Fischer
Inflation Targeting: The New Zealand and Canadian Cases 1

Edwin S. Mills
The Misuse of Regional Economic Models 29

Paul E. Godek
Bad Policy, Bad Law, and the Constitution: A Stiglerian View 41

Gary M. Anderson and Robert D. Tollison
Barristers and Barriers: Sir Edward Coke and the Regulation of Trade 49

Jonas Frycklund
Private Mail in Sweden 69

Emily Chamlee
Indigenous African Institutions and Economic Development 79

Herbert J. Walberg and Joseph L. Bast
School Choice: The Essential Reform 101

COMMUNICATIONS

Richard V. Burkhauser and T. Aldrich Finnegan
The Economics of Minimum Wage Legislation Revisited 123

Jim F. Couch and William H. Wells
Checking Out the House 131

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ELECTRONIC REPRODUCTION PROHIBITED

Thomas Havrilesky
The Politicization of Monetary Policy: The Vice Chairman as the Administration's Point Man 137

BOOK REVIEWS

Welfare Economics and Externalities in an Open-Ended Universe: A Modern Austrian Perspective
Roy E. Cordato

Reviewed by **Israel M. Kirzner** 143

Combating Poverty: Innovative Social Reforms in Chile during the 1980s
Tarsicio Castaneda

Reviewed by **D. Gale Johnson** 150

The Economics of Prohibition
Mark Thornton

Reviewed by **David R. Henderson** 152

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ELECTRONIC REPRODUCTION PROHIBITED

Inflation Targeting: The New Zealand and Canadian Cases

Andreas M. Fischer

Introduction

Canada and New Zealand have recently announced targets of zero inflation. The return to a "nominal anchor with drift" represents a new way of thinking about the objectives of Canadian and New Zealand monetary policy. The targets are bounded by formal agreements between the minister of finance and the central bank, thereby providing monetary policy with a strong commitment to price stability. The change in the (somewhat modified) Consumer Price Index (CPI) was chosen as the yardstick for measuring inflation, with price stability tentatively defined as a rate of CPI inflation between 0 and 2 percent.

While inflation targeting heightens the general awareness as to what the objectives of monetary policy are in Canada and in New Zealand, it is important to identify for whom the targets are intended. Large differences in the time frame of the target path may arise if the targets are designed for purposes of fiscal discipline, financial markets, or the public. At the same time, inflation targeting leaves many operational issues concerning monetary policy open. The issue of targets and instruments raises questions as to how monetary policy should be implemented. This paper draws from the experiences in Canada and New Zealand and examines the benefits and drawbacks of implementing inflation targets.[1]

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[1]The inflation target debate also has received attention in the United States, the United Kingdom and Australia. In the United States, Congressman Stephen L. Neal introduced a resolution in August 1989, asking the Federal Reserve to adopt a five-year, zero-inflation goal (Neal 1992). It was reintroduced in January 1991 where it was blocked in the House Banking Subcommittee on Domestic Monetary Policy. The chancellor of the Exchequer, Norman Lamont announced on October 8, 1992 inflation targets of

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The discussion is organized into four sections. First, the goal of price stability in Canada and New Zealand is defined. Second, alternative rule-based strategies for price stability are compared. Although no rule-based policy dominates the other in an absolute sense, the distinctive feature for inflation targeting is that rules are defined in terms of the final objective rather than an intermediate target. Third, tactics for implementing inflation targets are discussed. Several tradeoffs regarding the target path horizon, operating procedures, and the transparency of monetary conditions are highlighted. Considerations for a feedback rule in Canada and New Zealand are also discussed. Fourth, the recent inflation performances in Canada and New Zealand are reviewed.

The Goal of Price Stability and Institutional Reform

During the last two decades, economic circumstances and developments in economic theory have brought into sharper focus the difficulty of pursuing multiple mandates with the limited tools at a central bank's disposal. In particular, long-run effects of monetary developments on real variables are generally considered to be nonexistent, and attempts to influence real variables may be counter-productive. Consequently, it is thought that monetary policy should focus on the one goal it can control in the long run, the price level.

One way of controlling central bank policy is through legislation. The objectives of the Reserve Bank of New Zealand have changed significantly under the Reserve Bank of New Zealand Act 1989, which became effective on February 1, 1990.[2] The act makes price stability the sole objective of monetary policy.[3] Prior to this, monetary policy had a mandate to promote economic growth, full employment and low inflation. The New Zealand targets equate price stability with zero inflation. However, because of deflationary risks and mathematical and measurement biases in the construction of price indices, the interpretation favored by the Reserve Bank is 0 to 2 percent growth in the CPI. The act, furthermore, constrains successor governments to behave consistently in the long run, facilitating the build-up of the central bank's reputation. While nonbinding policies can

1 to 4 percent. In Australia, the Liberal opposition party has expressed active support for inflation targets as in Canada and New Zealand (see Stutchbury 1991).

[2]The main features of the Reserve Bank of New Zealand Act 1989 are outlined in Stephen Dawes (1992).

[3]Likewise, Canada has sought to make price stability the Bank of Canada's primary goal. Despite failed attempts to revise the preamble of the Bank of Canada Act, price stability is firmly recognized to be the overriding goal of Canadian monetary policy.

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be changed at low cost, changing objectives fixed by law, although possible, incurs greater costs because it is more visible to society.

An alternative route for governments to influence central bank behavior is to alter the central bank's incentive structure. Within the context of a principal-agent problem, Carl Walsh (1992), and Torsten Perrson and Guido Tabellini (1992) regard the announcement of targets as a contract between the government and the central bank. The government achieves its objective by altering the incentive structure of the central bank by either enforcing penalties (i.e., dismissal of the governor if the targets are missed) or by making transfer payments (i.e., ego boosting, increased salary, etc.). In this contract framework, the time inconsistency problem as defined in Robert Barro and David Gordon (1983) is resolved. In the next section, several types of target agreements are considered for small open economies.

The Strategy: Defining a Nominal Anchor

The abandonment of monetary targeting in the early 1980s left most central banks searching for an alternative nominal target that was not subject to shocks caused by technological innovation or by financial deregulation. While some countries were able to peg their currencies to a low inflation country, Canada and New Zealand adopted a "looking at everything" approach as an operational mechanism (see Freedman 1989, Spencer 1992). During the mid-1980s both countries made progress on the inflation front (see Figure 1), but it was felt that the multiple-indicator framework did not provide economic agents ample information about the seriousness with which the central banks were pursuing price stability. Given this problem, the past record of high inflation and corresponding low credibility in both countries during the 1970s and early 1980s, the respective governments and central banks believed that the private sector needed to be presented with proof of their determination to combat inflation.

This section considers alternative rule-based strategies for implementing the goal of price stability and argues why Canada and New Zealand chose the path of inflation targeting. Although George Alogoskoufis (1989) has shown formally that neither nominal income, nor exchange-rate targeting is sufficient to minimize the welfare costs of aggregate fluctuations and no strategy necessarily dominates the other, there may be distinct advantages in following a strategy of inflation targeting for some small open economies that have undergone an intensive program of financial deregulation.

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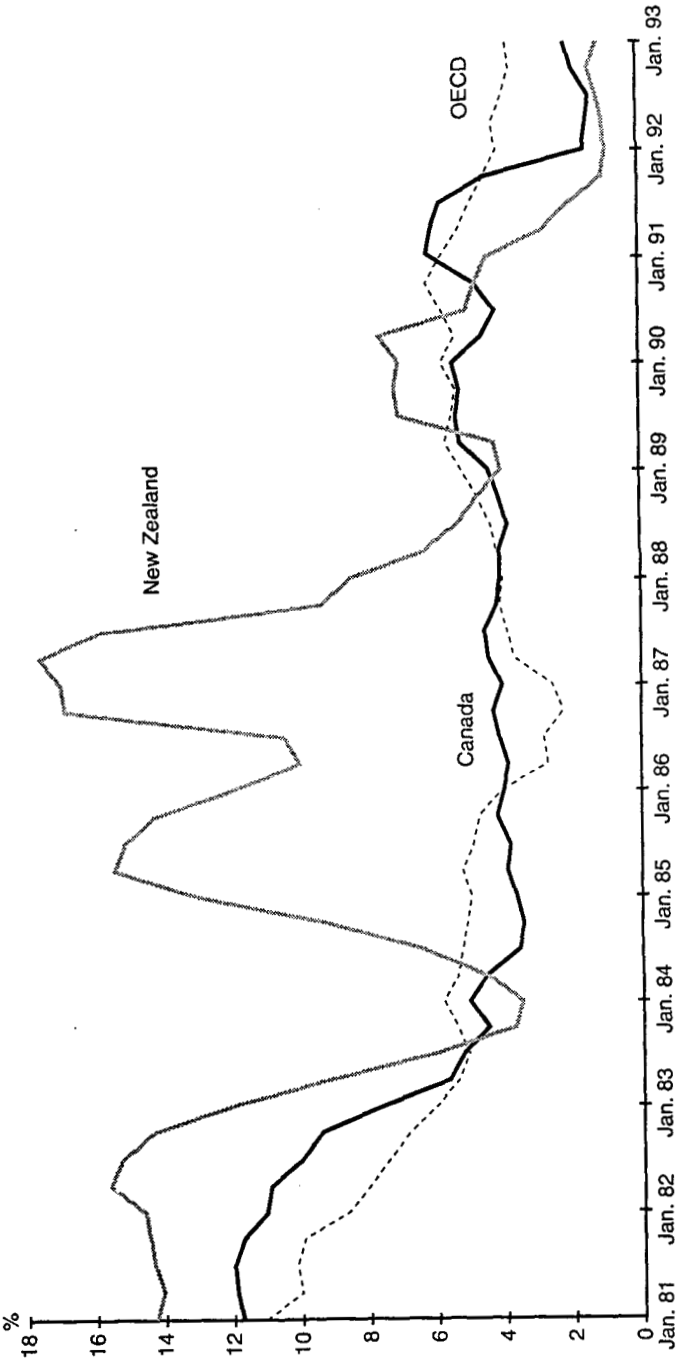
FIGURE 1

CONSUMER PRICE INDEX
(Percentage Change from Corresponding Period of Previous Year)



SOURCE: CANSIM-Statistics Canada.

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The Constant Money Growth Rule

Milton Friedman's (1960) argument for the constant money growth rule rather than an active feedback rule is that there are long and variable lags in monetary policy. Consequently, activist policy that responds to current events may effect prices at an inappropriate time. Uncertainty about the lag coefficients implies that active use of monetary policy adds variability to income. Active monetary policy may still be used cautiously to reduce the variability of output, but the gains are uncertain. Moreover, if the coefficients vary over time, it is even less likely that policymakers will have the necessary information to make activist policy optimal. A nonactivist policy may even be optimal if an activist policy adds uncertainty to the system independent of the particular policy being followed.

In recent years it has become clear that there are two problems with the constant money growth rule. First, technical progress in the payments industry and its random occurrence makes it difficult to know how much money growth will lead to zero inflation on average. Second, financial innovation has made narrow money subject to large portfolio shifts, making it an unreliable indicator of inflation. Charles Freedman (1983) cites this as the chief reason why Canada formally abandoned M1 targeting in 1982. Although targeting a broader monetary aggregate may internalize portfolio shifts, broad money is not itself a controllable instrument but is instead a variable that the monetary authorities can manipulate only indirectly. Hence, Friedman's rule is not fully operational. Moreover, monetary targeting is not a viable strategy in Canada and New Zealand because the short-run relationship with nominal output is found to be far from stable.[4]

Targeting Exchange Rates

An alternative rule is to target a nominal exchange rate to a low inflation country. In a certain sense exchange rate targeting, as under the Exchange Rate Mechanism (ERM) is an indirect form of inflation targeting, whereby credibility is gained from the targeted country. This approach is viable for a small country that suffers from a lack of self discipline and is willing to give up its monetary independence. The strategy of exchange rate targeting is easy to monitor since the

[4]In particular, it is difficult to infer whether the observed changes in the monetary aggregates are a reaction to past changes in nominal output or whether they are likely to lead to future nominal output changes. Alfred Wong and Authur Grimes (1992) provide a survey of the major empirical findings for New Zealand money demand and Kevin Clinton (1992) for Canadian money demand.

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target and the instrument are analogous, making the stance of the policy transparent.

The recent experiences of the Scandinavian countries suggest that picking a currency and targeting it may not be simple. In deciding whether to fix the exchange rate or to opt for a floating currency, small open countries must consider the type of shocks that they are subject to. For example, the periodic shocks in world prices of raw materials relative to those of manufactured goods would provide a strong argument for a small raw materials producer not to tie its currency to that of a large manufacturing country. Indeed, one of the adjustment mechanisms for the small raw materials producer is via the movements in the real exchange rate and, therefore, fixing or constraining the nominal exchange rate may hamper adjustments in such circumstances. Thus, in order for a country to benefit from pegging its currency to a low inflation country or optimal currency zone, the two countries must be subject to similar trade shocks. The fact that New Zealand suffers from terms of trade shocks that are independent from many other countries creates difficulties in choosing an exchange target.[5]

Furthermore, evidence from the ERM shows that those countries that entered the ERM with high inflation rates have experienced significantly increased unemployment. Hence either inflation expectations have not responded to the greater credibility of the disinflation policy, or labor market institutions and rigidities have prevented lowered expectations from translating into lower inflation. Thomas Egebo and Steve Englander (1992) note that in some ERM countries, such as the United Kingdom and Italy, there is little evidence of a downward shift in inflation expectations in labor and product markets after 1987, suggesting that there is no strong basis for concluding that adhering to the ERM bands alters the tradeoff between inflation and unemployment.

Inflation Targeting

The previously discussed rule-based strategies suffer from a common problem. The target is not the ultimate goal of the policy in question. Although intermediate targets such as exchange rates may influence expectations quickly, because they are easily observable, the precise relationship between these intermediate targets and the final objective is not clear. On the other hand, a multi-period target

[5]Although Canada may have an obvious choice in pegging its currency to the U.S. dollar, since its southern neighbor is its principal trading partner, previous experiments with exchange rate targeting have not resulted in low inflation.

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path for inflation forces the central bank to choose a monetary policy such that inflation falls in line with the target path. The next paragraphs outline the rationale for inflation targeting.

A primary motive for inflation targeting is to lower rapidly inflation expectations. The quicker individuals and businesses factor lower inflation into their pricing decisions, the faster nominal wages and prices will adjust downwards and thereby minimize the output losses from tight monetary policy. The speed at which expectations adjust depends on the public's faith in the central bank's ability to carry out the policy, conflicting short-run objectives, institutional rigidities in labor and product markets, and numerous other factors. Credible inflation targets over several years lay out a clear future path for inflation to which wage negotiations can refer over the disinflationary cycle. Understanding the motivations of policymakers and the nature of the announcements is important for altering the expectations of individuals and businesses. In defining the target path, policymakers need to strike a balance between promising a noticeable downward path for inflation in order to demonstrate their commitment, while ensuring at the same time that the target band appears achievable and sustainable.

A second case for the announcement of inflation targets is to constrain future government spending and improve the coordination between fiscal and monetary policy.[6] Formal agreements concerning inflation targets between the central government and the monetary authorities impose implicit limits on the future growth of central government spending. Inflation targets are intended to make budgetary spending allowances consistent with the projected inflation path as laid out in the targets agreement. In addition, a sustainable policy of zero inflation limits the government's inflation tax revenue and its ability to accommodate rising fiscal imbalances. Therefore larger government deficits can only be financed by future tax increases, putting politicians under greater pressure to answer calls as to how such resources are to be furnished.

A third important advantage is that inflation targets offer alternative strategies for removing the inflation bias, which have not been fully analyzed in the time inconsistency literature. Walsh (1992), and Perrson and Tabellini (1992) regard agreements on inflation targets as a contract between the government and the central bank. The introduction of transfer payments to the central bank limits the discretionary

[6]Inflation targets are also intended to limit government spending on the local level (see Robson 1991). In many OECD countries, program spending on the local, state, and provincial level has outpaced government spending in recent years.

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options for monetary policy and thereby enhances the institutional credibility of the central bank. Walsh (1993) suggests that inflation contracts are easier to monitor and enforce then if the contract were defined in terms of an intermediate target such as money. A related consideration is that the announcement of inflation targets enhances the government's accountability. Over time, voters should retrospectively be able to make an unambiguous assessment of the monetary authorities' performance on inflation.

Tactics for Implementing Inflation Targets

Introducing a program of inflation targeting involves various aspects: explaining the policy to the public, defining the target horizon, and choosing the operational instrument. This section reviews the tradeoffs for implementing inflation targets in Canada and New Zealand.

Contracting the Targets Agreement in Canada and New Zealand

Inflation targets in Canada and New Zealand are specified under a contract between the governor of the central bank and the minister of finance. Contracts raise many issues concerning the degree of precision about what monetary policy can or cannot be expected to do over a specified period of time. The challenge in negotiating the contract is to create a set of incentives and sanctions that encourages the central bank to achieve low rates of inflation over the medium term by conducting monetary policy in a consistent and predictable manner.

The Reserve Bank of New Zealand Act, which was passed by Parliament on December 15, 1989, made price stability the primary goal for monetary policy in New Zealand. The act mandates the governor and the minister of finance to agree on a definition of price stability and to announce this publicly in the Policy Target Agreement (PTA). The first agreement specified that monetary policy would be directed toward achieving a year-over-year inflation rate of 0 to 2 percent by December 1992 and maintaining of price stability thereafter. Partly out of concern that adjustment costs were too high, the new government elected in October 1990, deferred the target by one year (Nichols 1991). In February 1991, the Reserve Bank announced interim targets of 2.5 to 4.5 percent by December 1991, 1.5 to 3.5 percent by December 1992, and 0 to 2 percent by December 1993.[7] Similarly, agreements between the Bank of Canada and the

[7]See the "Appendix" in the *Reserve Bank Bulletin* of New Zealand (1990).

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Department of Finance announced inflation targets in February 1991 according to which the CPI was to fall to 3 percent by December 1992, 2.5 percent by mid-1994, and 2 percent by the end of 1995.[8]

Although inflation targeting is often thought of as a price rule, the targeting strategy in Canada and New Zealand is one of zero inflation and not of price level targeting. The terms price stability and zero inflation are often used interchangeably, however they imply two different policy objectives. Zero inflation is a price rule with drift, which ignores past changes in the price level whereas price stability does not (see Gavin and Stockman 1990; Lebow, Roberts, and Stockman 1992).

Apart from the fact that the target paths were announced at the same time and that the rate of inflation stood at about 6 percent in both countries at the time of the announcement, there are key differences in the Canadian and New Zealand target agreements. First, the shorter time frame suggests that the New Zealand strategy places more weight on achieving credibility at the risk of having an unbalanced policy mix between monetary and fiscal policy. The longer time frame of the Canadian targets gives the Bank of Canada greater flexibility to average out the price shocks.

The time frame of the target path for inflation raises alternative issues of credibility and dynamics. Olivier Blanchard (1985) has argued for a gradualist approach rather than drastic disinflationary measures. If a government imposes drastic disinflationary measures, it is possible that the public may fail to adjust prices and wages accordingly such that the resulting recession would be too deep, and thus politically unsustainable. Consequently, opposing parties favoring expansionary measures are likely to replace the current policymakers. In contrast, Ulrich Lachler (1988) argues for rapid disinflation. Given that some contraction in economic activity is inevitable, it would be preferable that the policymakers' desire to disinflate be tested early, during the initial stages of the targets program. This would provide a more immediate signal to the market that the government is prepared and politically able to stand by its commitment despite the possibility of an unpopular recession.

A second difference in the target path is that the Canadian agreement is subject to cancellation in the event of a political crisis, whereas the New Zealand strategy offers a greater degree of permanence and consistency under the Reserve Bank Act. Although the Canadian agreement gives the Bank of Canada considerable autonomy under the inflation target agreement, the New Zealand agreement is embedded in the Reserve Bank Act which guarantees a

[8]See "Background Note on the Targets," *Bank of Canada Review* (1991).

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high degree of central bank independence regardless of the type of monetary policy pursued.

A third notable difference is that the New Zealand strategy offers greater accountability. In New Zealand, the governor may be dismissed for missing the target. The Governor of the Reserve Bank also has to clarify the Bank's past and future actions on a timely basis every six months. These biannual reports provide the public valuable information regarding the Reserve Bank's assessment of the real and nominal economy and its view of inflation expectations. Moreover, the PTA states that should a temporary deviation occur the Reserve Bank must detail its response in an attempt to ensure that the effects of such shocks are transitory. The Bank of Canada is not mandated to specify the policies by which it intends to achieve its inflation targets, state the reasons for adopting these policies, nor provide an outlook for monetary policy over the next five years on a regular basis as is the case in New Zealand.

Credibility Management under Inflation Targeting

Disinflation becomes difficult to achieve when the public lacks confidence in the central bank's ability and willingness to carry out a newly announced policy. As mentioned earlier, central bank contracts as defined in Walsh (1992) and Perrson and Tabellini (1992) may resolve the time-inconsistency dilemma faced by central banks. However, other credibility problems may arise, forcing the government and the central bank to introduce additional measures.

First, a credibility problem may stem from incompatible programs. The public may recognize that the policy of inflation targeting is not compatible with other government policies that are being pursued simultaneously and that may undermine the central bank's ability to successfully carry out its policy. For instance, a disinflationary program that does not include measures to limit the public sector deficit is inconsistent and will therefore lack credibility with the public. Thus, announcing publicly a target path for inflation serves to alter the scope of future government spending and improves the coordination between fiscal and monetary policy.[9]

Canada and New Zealand announced fiscal consolidation targets at the same time that inflation targets were announced. Canada envisioned a balanced budget by 1996 and New Zealand by 1994. But these efforts to improve policy coordination have stalled due to the

[9]Lachler (1988) has argued that credibility problems may arise independently of whether the adopted policy mix is consistent or not from the unfavorable dynamic adjustment pattern associated with stabilization programs based on non-floating exchange rates in small open economies.

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adverse impact on government finances of weaker-than-expected economic activity over the past years. The self-imposed measures of fiscal discipline were delayed by one year in Canada and budget targets were abandoned in New Zealand. This slippage in policy coordination has resulted in a policy imbalance, placing a greater burden on monetary policy.

A second credibility problem is that of incomplete or asymmetric information: private agents may not be able to assess the seriousness or speed at which the central bank is attempting to disinflate. This type of credibility problem differs from the time inconsistency case whereby the public perceives too well the policymaker's underlying intentions. Imperfect information prevails in countries where monetary policy tends to change frequently, hence creating confusion about the objectives of monetary policy. An announced target path for inflation with specified dates informs the public regarding the speed of the disinflation process.

A third form of credibility problem results from uncertainty regarding the predictability of inflation targets. Even if the program of inflation targets is well formulated and time consistent, in the sense that the monetary authorities do not have any incentive to deviate from the announced policy, exogenous shocks may occur, disrupting policy. The public is aware that the monetary authority is unable to precommit its actions in response to each state of the environment and that the relationship between inflation shocks and the authority's instruments is not precise. Thus inflation targets may introduce escape clauses that act as a contingent mechanism to eliminate the predictability problem. In order to avoid problems of time inconsistency it becomes important for the rule-based policy to explicitly outline in advance which shocks monetary policy will and will not accommodate.

The Canadian and New Zealand targets state that not all inflationary shocks are to be offset. The inflation strategy in Canada allows for adjustments to the targets when there are changes in indirect tax rates that lead to abrupt effects on inflation, whereas New Zealand allows for temporary deviations from targets in the event of increases in indirect taxes, terms of trade shocks, and natural disasters. Special circumstances are outlined regarding the precise nature of the supply shock, yet threshold levels (warranting intervention) pertaining to the size of the shock are not defined. This raises the issue of target specification, i.e., the option of having a wider band and/or a long-run specification (for example average inflation over a multi-year period). These options could allow supply shocks to be addressed within the boundaries set by the inflation target, rather than being

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treated as exceptions. Such a procedure avoids the problem of defining threshold levels for intervention regarding particular shocks or making arbitrary decisions about whether a real or nominal shock has occurred.

Defining Inflation and the Target Path

The type of targeted price basket has important implications regarding the choice of the instruments to be used by the monetary authority. The argument for focusing on a narrow group of prices such as the price of gold or an exchange rate is that they are relatively easy to target and monitor. For example, if the price rule is based on the exchange rate, then the choice of the price basket and the instrument are analogous. A fixed exchange rate, however, does not necessarily result in zero inflation over a broad basket of goods prices, and places the burden of adjustment primarily on the export sector. Although, stabilizing a broad index is preferable in order to attain the desired adjustment in prices in general, a basket index raises alternative questions regarding the definition of zero inflation.

Canadian and New Zealand inflation targets are expressed in terms of the CPI, and price stability is defined as an inflation rate of 2 percent, or less. Although the alternative measure, the GNP price deflator is broader in coverage, it is subject to large and frequent revisions over long periods of time, making it less appropriate to serve as a basis for targeting inflation. The CPI makes tracking inflation easier because it is published on a regular basis, without long delays, and is rarely revised. Differences between the CPI and alternative measures of inflation should be at least consistent or identifiable in the long run.

The difference between the theoretical concept of the cost-of-living index and the calculated CPI can generate four types of biases: the substitution bias, the new-goods bias, the outlet substitution bias, and the quality bias.[10] Pierre Fortin (1990) estimates that the Canadian CPI is subject to an upward bias of an estimated magnitude of perhaps 0.5 to 1 percent per year if the effects of the substitution and new-goods biases are added up. David Rae, Michele Lloyd, and Andrew Fung (1992) find that the total of the four types of biases amounts to approximately 0.5 percent in New Zealand. Although this figure is below those typically quoted for other countries, they argue that the bias is negligible and the Reserve Bank could target 0.5 percent annual inflation if it had the ability to be this precise.

[10]A good discussion of the issues concerning the various CPI biases can be found in Fortin (1990).

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The fact that Canadian and New Zealand inflation targets are set in terms of a 1 percent plus or minus band reflects the reality that policy changes cannot be calibrated so as to achieve an exact rate of increase in prices.[11] As a practical matter, even though Canadian and New Zealand targets are set in terms of total CPI, policy actions are based on a modified index. The Bank of Canada bases its policy actions on a CPI excluding food and energy prices. Because the two CPI components are often volatile with respect to total CPI, it is inappropriate for monetary policy to try to offset their short-run fluctuations (see Figure 2). Alternatively, New Zealand has opted to use a CPI modified to exclude house-purchase and mortgage costs.[12]

Price Lags and Inflation Forecasts

Monetary authorities do not have absolute control over the price level, because the lag between changes in monetary conditions and inflation is long and uncertain. Operationally, the lagged adjustment of prices presents several difficulties for inflation targeting. First, monetary policy seems to operate more slowly on prices than on real GNP. Inflation targeting could cause significant fluctuations in real GNP in trying to stabilize inflation, particularly if the dynamic behavior of prices is unknown. For instance, John Taylor (1985) finds a weak negative tradeoff between the variance of prices and the variance of real output for several countries. Table 1 shows that among several OECD countries, two low inflation countries, Germany and Switzerland, have a higher variance in output than in inflation.

A second potential problem is that the sluggish behavior of prices forces monetary policy to react to inflation forecasts, not to current inflation. Traditionally, the central bank's checklist of inflation indicators includes the exchange rate, the level and structure of interest rates, the wage rate, the output gap, and monetary aggregates, although the Reserve Bank of New Zealand tends to place less weight on the last indicator than does the Bank of Canada. However, the reliance on forecasts based on key indicators makes policymaking arbitrary. Although economists have become increasingly sceptical about the ability to forecast the future path of the economy, the size of the forecast errors may depend on the policy regime. For example,

[11]Canadian and New Zealand targets are regarded as midpoints of a target band of plus or minus 1 percent. Midpoints of the range are the objective of monetary policy in both countries, rather than the upper or lower band.

[12]The housing sector is not fully excluded because imputed rents are still included. Following the Iraqi invasion of Kuwait, the Reserve Bank announced that oil would also be removed from the targeted index.

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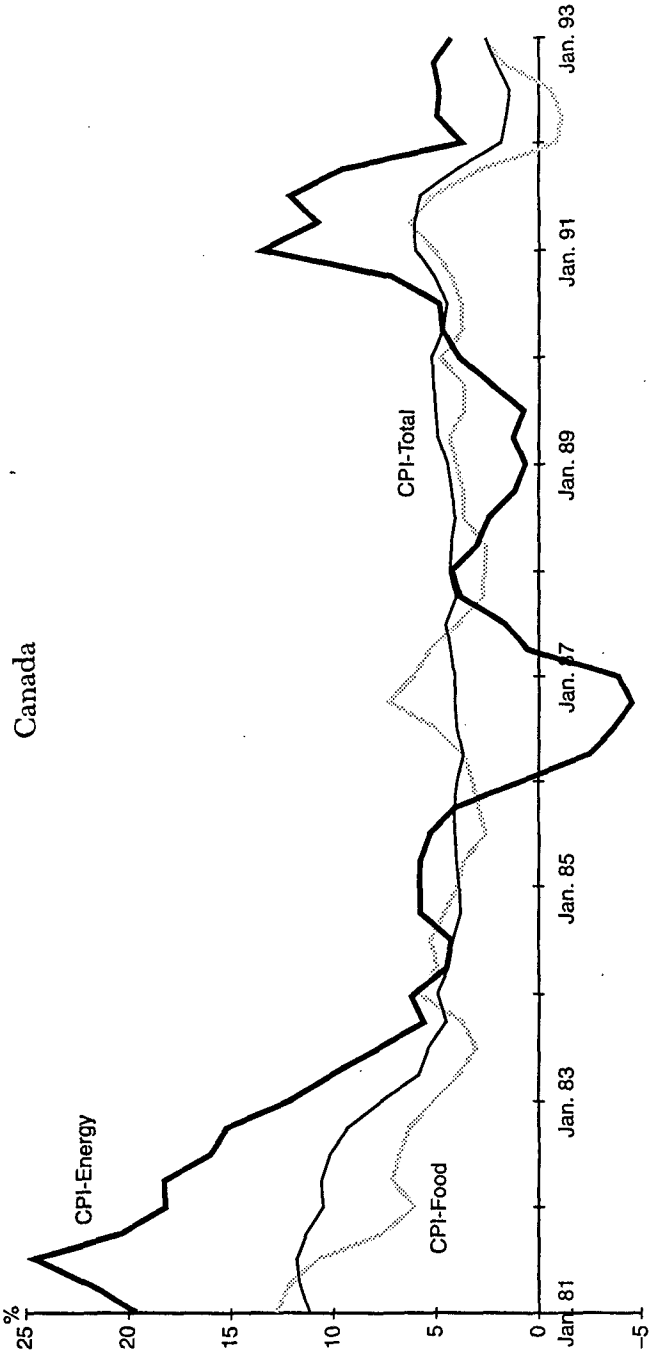
FIGURE 2

CANADA AND NEW ZEALAND INFLATION PERFORMANCE
(Percentage Change Over Four Quarters)



SOURCE: OECD, Main Economic Indicators

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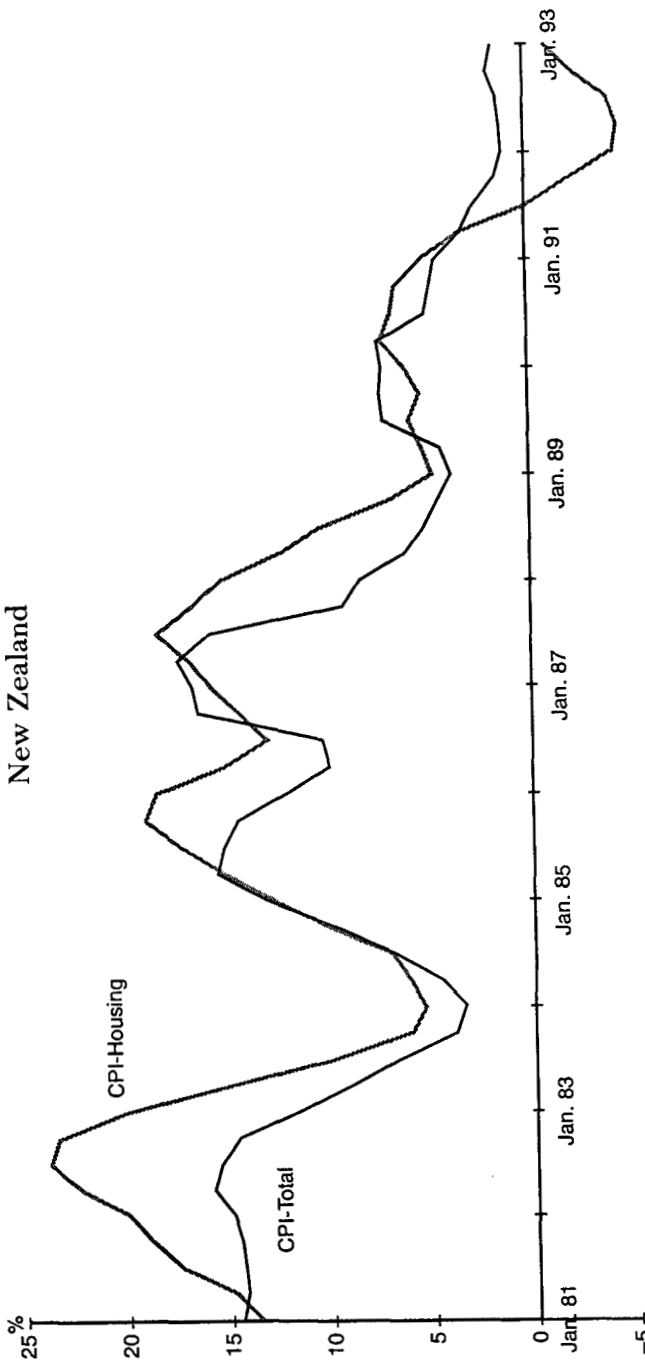

SOURCE: OECD, Main Economic Indicators

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TABLE 1

GDP GROWTH AND INFLATION, 1960–91
(Average Annual Growth and Variance)

	GDP Volume		Consumption Deflator	
	Growth	Variance	Growth	Variance
United States	2.9	5.3	4.9	6.2
Japan	6.3	12.2	5.3	16.8
Germany	3.1	4.7	3.5	3.3
France	3.6	3.6	6.6	13.7
Italy	3.8	6.0	9.3	37.1
United Kingdom	2.3	4.6	7.7	26.5
Canada	4.0	6.3	5.2	8.8
Australia	3.7	5.7	7.0	17.6
New Zealand	2.2	17.5	8.5	30.7
Belgium	3.4	4.6	4.8	8.8
Switzerland	2.6	7.1	4.2	5.2
Denmark	2.8	7.1	7.1	10.2
Spain	4.5	9.1	9.9	28.0
Greece	4.5	14.0	11.4	62.6
Ireland	4.1	5.3	8.5	36.8
Iceland	4.5	17.7	24.9	357.4
Norway	3.7	3.5	6.6	7.9
Sweden	2.7	4.1	7.4	10.8

SOURCE: OECD, National Accounts.

Allan Meltzer (1987) claims that discretionary policy actions increase uncertainty and the size of the forecast errors.

Instruments, Targets, and Operational Rules

A policy rule that pegs an intermediate target serves as an operational guide for a two-stage process. The policymaker first chooses a time path for some target variable that promises to lead to desirable outcomes for the goal variables. Then in the second stage, policy efforts are focused on an attempt to achieve the designated path for the target variable. For example, the monetary authority may select a target path for the money stock, in the belief that this path will lead to a desirable combination of inflation and output realization.

Whether inflation targeting also follows a two-stage process depends on the dynamics of the optimal control process. Simple examples of an operational rule are given by Barro (1986), Bennett McCallum (1989), and Daniel Lebow, John Roberts, and David

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Stockton (1992). Barro and McCallum envision an inflation targeting regime that involves a feedback relationship where an inflation rate above target for a specified length of time triggers lower growth of the monetary base, and vice versa for an inflation rate below target. The objective could involve a moving path of prices that allows for non-zero inflation over time. However, after an initial disinflation phase, the simplicity of the rule, as well as prevention of discretionary adjustments to the level of prices, argues for specifying the target as a constant price level.

In practice, whether such simple operational rules exist for inflation targeting is doubtful. The experiences in New Zealand and Canada argue against simple feedback rules for inflation. Grimes and Wong (1992) argue that the Reserve Bank of New Zealand forecasts inflation pressures arising from all sources other than the exchange rate and determines a path for the exchange rate range that is consistent with price stability. The tolerance band for the exchange rate may vary over time according to price deviations from the target path. In this case, the exchange rate acts as a nominal anchor but not in the strict sense of an intermediate target as under a fixed or a pegged exchange rate rule.[13] In Canada adjustments to inflationary pressures have taken place in either the foreign exchange market or in short-term interest rates.[14] Since the announcement of the inflation targets, the Bank of Canada has not introduced any new operational changes and continues to follow a checklist approach of leading indicators.

Preliminary Evidence of Inflation Targeting in Canada and New Zealand

The main measures for assessing the success of monetary policy are the actual path of inflation, the way in which inflationary expectations are changing, and market confidence that a consistent and predictable approach is being maintained. Given that a large contribution to the Canadian and New Zealand disinflation process arose from the widening output gap, the gains from the inflation targeting strategy remain difficult to assess. In the following discussion I shall not evaluate the adjustment costs of the recent disinflation.[15]

[13]The Swedish experience of price level targeting during the 1930s operated primarily through the exchange rate (see Jonung 1979, Black and Gavin 1990).

[14]For an outline of recent Canadian monetary policy, see OECD (1992) *Country Survey, Canada.*

[15]The permanent and transitory costs from the previous Canadian disinflations are examined in Fortin (1991) and Barry Cozier and Gordon Wilkinson (1990). Jack Selody (1990) provides an overview of the empirical findings for Canada.

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However, the rapid fall in price expectations since 1991 is in stark contrast to the persistent gap that existed previously between actual and expected inflation. Nevertheless, the next few years will provide a clearer test of the credibility effects of inflation targeting, especially as economic activity revives.

Undershooting the Intermediate Targets

The eagerness to lower inflation means that central banks have to tighten monetary policy, but to avoid undershooting they have to ease substantially before hitting the intermediate target. The recent Canadian and New Zealand experience of actual inflation and inflation targets reveals that they have or are likely to undershoot their intermediate targets, despite easing before hand.[16] New Zealand undershot its 1991 and 1992 intermediate targets. In Canada CPI inflation, amounting to 2.1 percent in December 1992, was at the low end of the first target range of 2 to 4 percent. Apart from Australia and Iceland, Table 2 reveals that the disinflation process in Canada and New Zealand has been the quickest among the OECD countries over the 1990–92 period.

One interpretation attributed to undershooting behavior is the weaker than anticipated economic activity: a sluggish world economy and a stronger than expected exchange rate. An alternative interpretation of the undershooting behavior is the asymmetric risk involved in missing the intermediate targets under a policy that does not have absolute control over the targeted variable. If inflation acts as a scorecard for central bank behavior and reputation building equates to hitting the intermediate targets, then there is a tendency for central banks to err on the downside. In this case the targets embed a strong disinflationary bias. Furthermore, the need to meet the inflation targets together with a sceptical private sector can also instill adaptive behavior. Private decisionmakers need to see low inflation numbers before they are willing to alter their expectations. Recognizing this, the central bank is eager to bring CPI inflation down rapidly at the introductory stages of inflation targeting in the hope that credibility is gained quickly and expectations are altered.

[16]In New Zealand, the September 1991 easing of monetary policy was the clearest example of an explicit policy response to an improved inflation outlook. A reassessment of the Reserve Bank's inflation forecasts encouraged the Reserve Bank to ease monetary conditions in order to prevent inflation in 1992 from undershooting the 1.5 to 3.5 percent indicative range, knowing that the 1991 outcome was already beyond influence. See "Monetary Policy Statement," *Reserve Bank of New Zealand* (February 1992).

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Empirical evidence of asymmetric behavior can be found in Canadian financial markets. During the initial phase of inflation targeting, financial markets expected the Bank of Canada to offset positive inflation surprises (see OECD *Country Survey, Canada* 1992, Annex II; and Fischer 1993). Interest rates reacted strongly when monthly CPI announcements were higher than expected. However, the opposite case of lower than anticipated CPI inflation produced no change in Canadian asset prices.

Survey Data

Longer-term inflation expectations have declined in New Zealand and Canada. In New Zealand, the Reserve Bank's survey of businesses' two-year ahead inflation expectations are within the target range—averaging 2 percent for the end of 1993—implying some evidence of credibility. The survey results plotted in Figure 3 are supported by the behavior of nominal wage increases of only 1 percent in the first two quarters of 1992, coinciding with the current CPI inflation.

The Canadian survey data compiled by the Conference Board suggests that short-term expectations concerning inflation have fallen considerably. The decline in the expectations series plotted in Figure 3 is consistent with the sharp deceleration in prices. While these survey results may indicate a gain in near-term credibility there is no evidence of credibility effects in the labor market that might reduce the short-term costs of disinflation. The wage response to changes in employment conditions has remained in line with the previous two recessions. Nominal wage increases in the first two quarters of 1992 continued to increase by over 3.5 percent with an unemployment rate of over 11 percent—a level which is 4 percentage points higher than before the recession.

Labor Contracts

The duration of new labor contracts negotiated after the targets announcement is another indicator of labor market confidence in the targeting strategy. Reduced uncertainty about future changes in prices,—one of the rewards of low inflation—should result in longer-term contracts and thereby increased productivity (i.e., less days lost from work stoppages and contract negotiations). Figure 4 reveals that lower Canadian inflation has not translated into a shift towards longer term contracts. Rather the opposite has occurred, the percentage of new one-year contracts increased sharply after the introduction of the Goods and Services Tax in 1991.

The New Zealand experience suggests that low inflation together with institutional reform may increase the duration of employment

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TABLE 2

CONSUMER PRICES
(Percentage Changes from Previous Period, not Seasonally Adjusted)

	Year End Annual Rates						At Actual Rate
	1970–79	1979–88	1989	1990	1991	1992	12 Months to Latest Month Available (May 1993)
	Average						
United States	7.6	5.1	4.6	6.1	3.1	2.9	3.2
Japan	9.1	2.3	2.6	3.8	3.6	1.2	0.9
Germany	5.1	2.8	2.8	2.7	3.5	3.7	4.2
France	9.6	7.3	3.0	2.8	4.2	2.0	2.0
Italy[a]	14.0	10.9	6.5	6.3	6.0	5.1	4.5
United Kingdom	13.4	6.9	6.6	6.1	6.4	2.6	1.3
Canada	8.3	6.3	5.2	5.0	3.8	2.1	1.8
Austria	6.3	3.7	2.9	3.5	3.1	4.2	3.7
Belgium	7.6	4.8	3.6	3.4	2.8	2.4	2.7
Denmark	9.8	6.6	4.8	2.7	2.4	1.5	1.0
Finland	11.4	7.2	6.6	4.9	3.9	2.1	2.6
Greece	14.1	19.1	14.8	22.9	18.0	15.0	16.4
Iceland	33.2	38.0	25.2	7.2	7.5	1.5	0.9
Ireland[b, c]	13.4	9.1	4.6	3.1	3.2	2.3	3.6

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Luxembourg	6.7	4.8	3.4	3.7	3.1	2.9	3.5
Netherlands	7.4	2.9	1.3	2.6	4.9	2.6	2.3
Norway	7.9	8.6	4.2	4.4	2.9	2.2	2.5
Portugal[b]	19.6	17.4	11.6	13.7	9.2	8.4	5.7
Spain	15.6	10.1	6.8	6.5	5.5	5.4	4.6
Sweden	9.0	7.8	6.6	10.9	7.9	1.8	4.8
Switzerland	4.9	3.2	4.9	5.3	5.2	3.4	3.6
Turkey[d]	27.3	47.3	64.3	60.4	71.1	66.0	65.0
Australia[c]	10.7	8.3	7.8	6.6	1.5	1.3	1.2
New Zealand[c]	12.3	11.8	6.7	5.0	0.9	0.8	1.0

[a]Index for households and salary earners.
[b]Excluding rent.
[c]Since consumer prices are available only on a quarterly basis, the figures shown for the rates of change over 12 and 6 months are calculated as the rate of change over 4 and 2 quarters respectively to the last quarter available. The monthly rate is calculated as the change between the two most recent quarterly indices, expressed at a monthly rate and centered at the mid-month of the quarter.
[d]1970–1981: Istanbul index (154 items); from 1982, Turkish index.
SOURCE: OECD, National Accounts.

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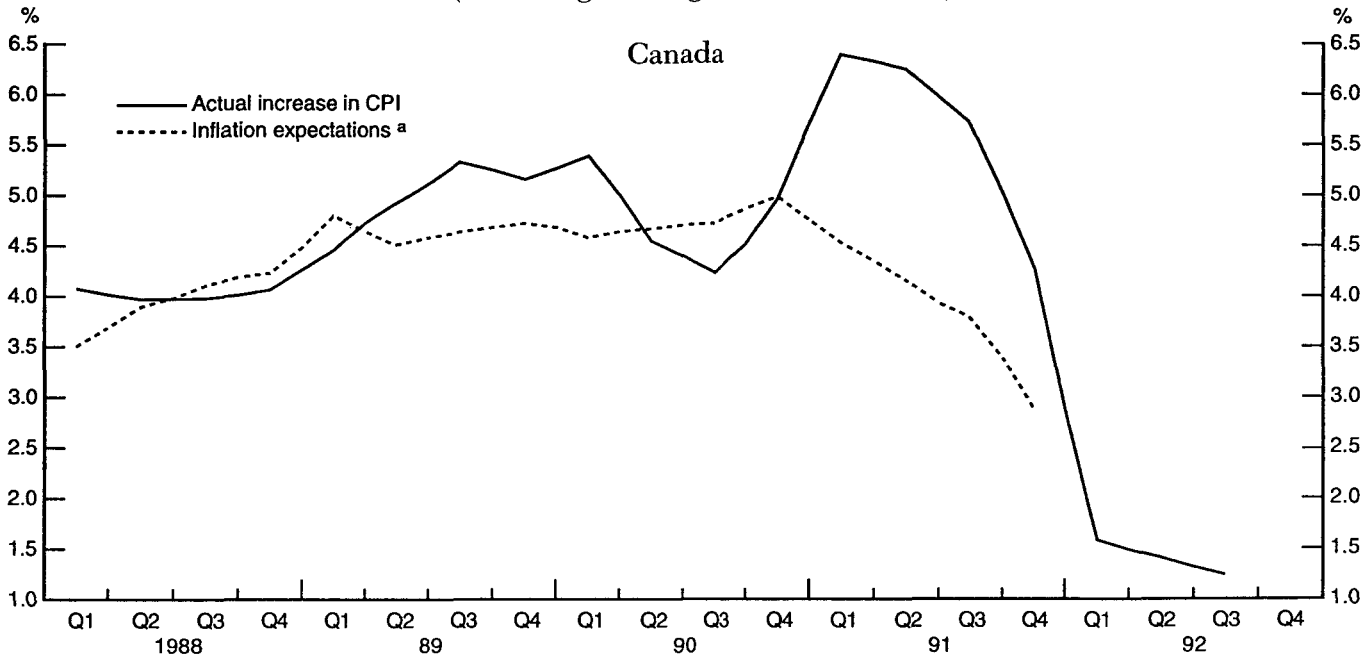
FIGURE 3

ACTUAL AND EXPECTED INFLATION PERFORMANCE:
CANADA AND NEW ZEALAND
(Percentage Change Over 12 Months)



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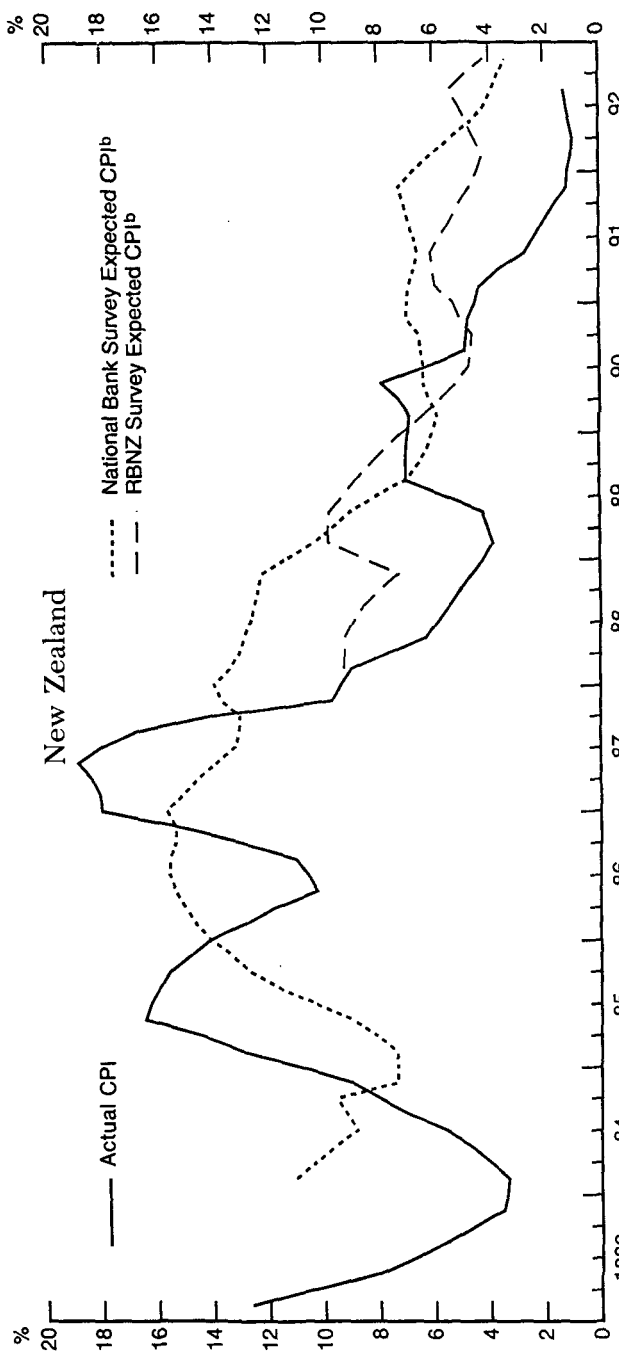

[a]Expected price increased in the next six months at an annual rate.
[b]Survey of inflation expectations of households 12 months ahead.
SOURCES: Conference Board of Canada; Reserve Bank of New Zealand.

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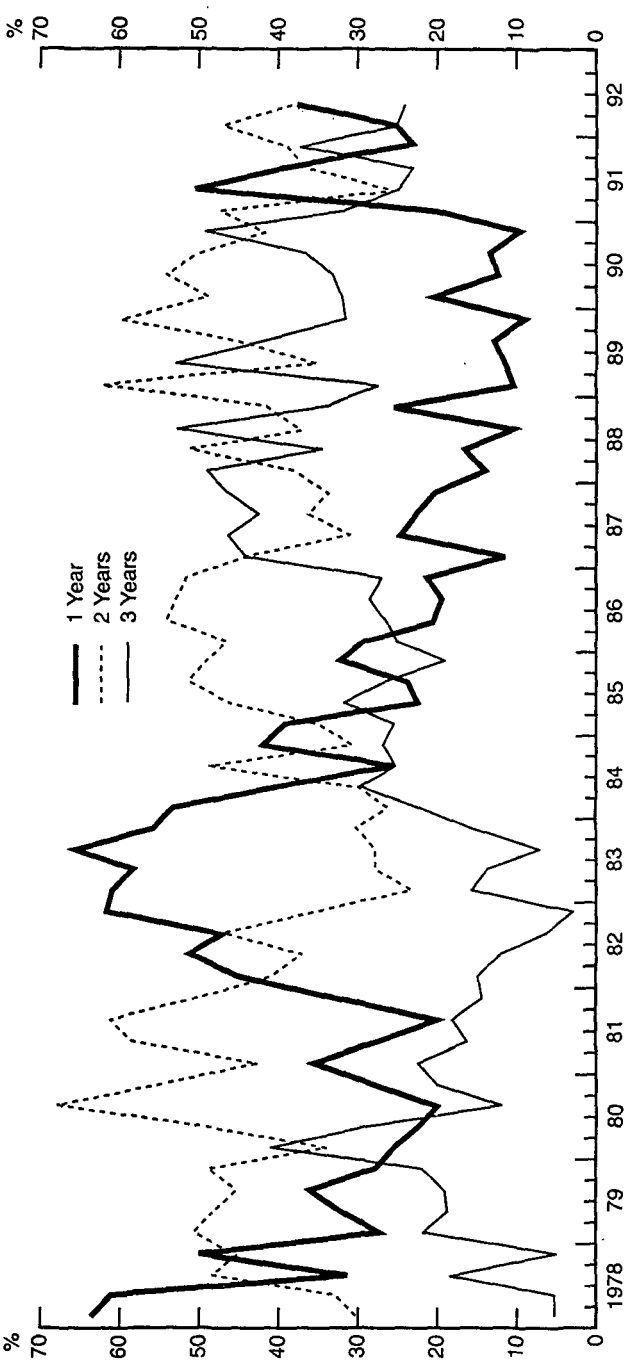
FIGURE 4

SETTLEMENTS BY DURATION OF AGREEMENTS
(As a Percentage of Total)



SOURCE: CANSIM-Statistics Canada.

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contracts. Prior to 1991, the only duration for any fixed-term contract was one year. However, the combined effects of lower inflation and the Employment Contracts Act, introduced in 1991, have increased the percentage of long-term contracts. In 1991, 41 percent of employees covered by collective contracts had contract terms of more than one year.

Conclusion

Inflation targets are defined in terms of the final objective of monetary policy rather than in terms of targets for instruments such as the money stock or nominal GNP. Although survey data highlight that inflation targeting has brought some credibility to the central banks of Canada and New Zealand, the ill-fated attempts to impose fiscal targets along with the undershooting of the intermediate targets, reveal that such a strategy may suffer from credibility problems stemming from inconsistent programs. The experiences in Canada and New Zealand reveal that the announcement of such targets has the primary purpose of providing a standard of accountability for public officials.

Canada and New Zealand have shown that their central banks are committed to the target strategy and that low inflation was achieved quickly. Overall, however, it is too early to determine the success of the policy of inflation targeting. First, one must wait and see how the two economies will react to the new environment of zero inflation, despite considerable costs of high unemployment during the disinflation phase. Moreover, once 0 to 2 percent CPI inflation has been achieved, the next step calls for ensuring that price stability will be maintained. This second phase of locking in and sustaining low inflation will be more difficult. Second, the global slowdown in economic activity and the unanticipated slow response to aggregate domestic demand helped Canada and New Zealand considerably on the inflation front. Thus, it is difficult to determine whether inflation targeting was successful at a time when most countries experienced little or no inflationary pressures. The real test of the policy comes when either central bank is faced with an independent domestic price shock.

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The Misuse of Regional Economic Models

Edwin S. Mills

Introduction

That economic analysis is sometimes used selectively and prejudicially to support positions motivated by self-interest or ideology is hardly news to most scholars. The purpose of this paper is to describe an important example of the misuse of economic models to support ideology and self-interest of state and local government officials. Billions of dollars of taxpayers' money are at stake.

The subject of the paper is the use by state and local governments and their consultants of regional economic models in order to justify proposed government projects in physical capital facilities. The models are used in ways that systematically exaggerate the public benefits of proposed government projects, thus biasing government decision-making in the direction of excessive government spending and expansion into areas that should be left to the private sector.

Most state and local governments require that economic impact studies be undertaken before important proposed investment projects can be approved. The purpose of economic impact studies is similar to that of environmental impact studies: to measure the positive and negative economic impacts of a proposed project on people and businesses in the surrounding areas. That is certainly a desirable goal; most scholars would agree that no important government project should be undertaken without a prior economic impact study. It is also important that such studies be carried out objectively and with models that are appropriate for the purpose.

This paper analyzes the use of a model called REMI in economic impact studies. REMI is an acronym for Regional Economic Models

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Incorporated, a firm in Amherst, Massachusetts of which George Treyz is president. Two facts justify concentration on REMI in this paper. First, it is widely used, perhaps more widely used than any similar model. Second, it is available in explicit detail in publicly accessible papers. Several consulting firms have regional models of one kind or another, but most consultants keep their models proprietary and there is no easy way to evaluate them. The same is true of most macro models owned by profit-making consulting firms. To REMI's credit, the REMI model is completely public.

Two excellent surveys of economic impact studies and related regional models are Nijkamp (1986) and the *Journal of Regional Science*, vol. 25 (1985). Roger Bolton's (1985) contribution is especially valuable. Based on these surveys, reading of dozens of published model documents, and reading of many impact analyses undertaken with proprietary models, REMI appears to be among the very best regional impact models extant. Much research and hard work have gone into REMI's formulation and estimation; much of its content is based on publications in scholarly journals. Thus, my at times severe criticism is of the ways REMI is misused, not of REMI itself. Any model can be misused. How responsibility for misuse of REMI should be divided between REMI staff and the government officials who use it, I have no way to ascertain.

The Model

A Brief Description

The description of REMI in this section is based on careful reading of all REMI reports available in early 1992. Relevant published and unpublished papers are listed in the references. Like any such model, REMI evolves and becomes more detailed and complex as time passes. REMI has been estimated for states, counties, and groups of counties such as metropolitan areas. Inevitably, more detail is available for some places than for others.

The most detailed version of REMI contains 49 private production sectors. Production functions are Cobb-Douglas, relating sectoral output in the region to sectoral labor, capital, and fuel inputs, assuming constant returns to scale. Regional share coefficients indicate shares of inputs purchased locally, and are determined in the same way that regional export shares are determined. Shares of sectoral production exported from the region are similarly set by share coefficients, which depend on endogenous regional prices relative to national prices for each sector. Regional consumption of each locally produced consumer good and service is proportional to local dispos-

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able income, allowing for regional variation in consumer demands. Local prices are set by local production costs, but do not affect the composition of local demand. Disposable income is correctly defined as earnings plus property income plus government transfers minus taxes paid. Sectoral investment equations bring sectoral capital stocks to their desired levels, determined by marginal productivity conditions. Local wage rates are determined by demands for workers in various occupations, by overall demand and supply for local labor, and by national wages and local consumer prices. Labor demand adjusts gradually to the level indicated by equilibrium labor market conditions. The local labor force depends on the local population, adjusted for labor force participation rates by cohorts. Cohorts are adjusted by births, deaths and aging. Economic migration between the region and elsewhere is modeled as a function of income and amenities in the region relative to national averages.

The model's representation of government sectors is crucial for this paper. Personal taxes per dollar of personal income (less transfers) equal national average taxes per dollar of personal income (similarly adjusted) multiplied by a local tax factor. Personal taxes per dollar of adjusted personal income do not vary with government policy simulations carried out with the model. Government spending is represented by six equations, one each for: federal civilian; federal military; state and local education; state and local health and welfare; state and local safety; and state and local miscellaneous. The first two categories are exogenous. State and local spending in each of its four categories is proportional to the region's share of national population, adjusted for national average state and local spending and a local factor. Analyses of government expenditure on proposed projects and policy simulations are carried out by adding terms to relevant equations to represent the government actions. For example, spending on a proposed state or local government project would be represented by terms added to the demand equations for inputs needed to produce the project.

Evaluation of the Model

The key point about REMI's representation of government sectors is that the model contains no budget constraint for any set of governments. There is no requirement that state and/or local government tax receipts plus user fees plus transfers from other governments plus increase in indebtedness equal expenditures. In fact, there is no exhaustive list of government receipts and expenditures. For example, there is no government debt or debt service in the model.

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REMI is calibrated one region at a time, based on estimates using data from all states. REMI has been estimated for all 48 contiguous states to ensure that state estimates add up to 48-state totals that are consistent with a national 48-state model. Particular state or local projects are small relative to 48-state totals, and there is of course no way to analyze an exhaustive set of state and local proposals in all 48 states. The implication is that the national government's budget constraint is of relatively minor importance in the model. For example, a national decision to build a military base in a particular county would have only negligible effects on national taxes paid by residents of the county. However, a county government decision to build a domed stadium to be financed by county government funds logically implies some combination of reduction in other spending by the county government, increased taxes in the county or increased indebtedness by the county government. State government projects are somewhere between the above extremes. A convention center to be built in a particular municipality and to be financed partly by the municipal government's funds and partly by state government funds requires some tax increases, or other changes among those listed above, in the municipality. Using state government funds requires state tax increases, or other changes among those listed above. But state tax increases (if that is the method of financing) paid by local residents are a large or small part of the total costs paid by the state depending on how large the municipality is relative to the state and on the pattern of state tax increases. The remainder of the required state tax increase is paid by state residents outside the municipality, but they are not represented in the model analysis.

The implication of the above is that REMI makes it appear that all increments to government spending, federal, state and local, for projects REMI analyzes are free. To finance new government projects, the model introduces no extra taxes, no cuts in other government services or transfers, and no increase in government indebtedness. Many projects whose impacts are analyzed by REMI are infrastructure investments. Frequently, capital costs are to be paid by governments and the facility is expected to generate revenues from user fees that will cover operating costs. Since most infrastructure projects are capital intensive, REMI evaluates the projects as though the capital were free. There is no opportunity cost of government project spending in REMI.

The contention here is not that there are no federal, state or local taxes in REMI. It has been shown above that there are. Indeed, it is possible that state and/or local taxes might be so high that REMI would predict that they would drive workers and/or businesses from

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the jurisdiction. State and local government spending is basically driven by population in REMI. Thus, if a proposed government project would increase population and employment, REMI calculates increases in government tax receipts and spending that would result from the changes in population and employment. But REMI is used to analyze government projects, not overall state and/or local government spending or receipts. Nothing in the REMI model requires that government project spending be matched by tax receipts that would cover parts of project costs not covered by money from other sources.

A state or local government project may nevertheless have some adverse effects on the local economy, according to REMI. If there is little local unemployment and inmigration is not very responsive to increases in local wages, then a proposed government project may reduce private output and employment. Some output and employment are transferred to the government sector. But it is impossible for REMI to indicate a reduction in total real private income from a proposed government project. This is an implication of the structure of the model, not of particular parameter sets. Since a project requires no increased taxes or other measures that might deter private spending, total employment and private income are predicted by REMI to rise as a result of any government project spending. If there is any labor response because of inmigration or reduced unemployment, REMI inevitably shows an increase in total employment and private income from any proposed government project analyzed. The model result occurs regardless of the project's merits.

The conclusion is that REMI inevitably exaggerates the benefits of government projects. The opportunity cost of state and local government funds for projects is represented to be zero. In fact, REMI is certain to show that the transfer of any project or economic activity from the private to the government sector is socially beneficial. REMI contains nothing that could permit the model to indicate that the private sector has a comparative advantage in producing any good or service. Hence, a transfer of an activity from the private to the government sector avoids the private sector's capital costs, while at the same time failing to register governments' expenditures in capital and labor as costs. Thus increases in consumer welfare result (since the private sector had to charge prices that covered costs whereas the government can give the good or service to consumers). Total earnings are unaffected, since the same employment and wage rates are required in the government as in the private sector.

None of the above relies on choices of particular parameter values for REMI. The conclusions are inherent in REMI's structure.

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How REMI Is Used

I do not have an exhaustive list of applications of REMI. REMI has kindly furnished a list of REMI projects and REMI clients, but I have come across several economic impact studies done for proposed state and/or local government projects that indicate that REMI was employed, but are not on the lists furnished by REMI. Nevertheless; between the lists furnished by REMI and applications that have come to my attention in other ways (mostly reports sent to me in connection with other work), it is my estimate that I have seen nearly 100 applications of the model. (Some analyses may appear in more than one source.) That is probably a quite representative list of REMI applications.

I have no way to calculate accurately how much money is involved in government projects that REMI has been used to analyze. However, projects that I know about plus descriptions of analyses furnished by REMI make clear that, in the last five to ten years, REMI has been used to analyze projects whose costs are many billions of dollars. Likewise, it is impossible to know how much influence REMI has had in the process of project approval. REMI calculations are advisory to the political process. However, government agency statements in support of proposed projects frequently quote REMI calculations as to how many jobs and how much taxes the project will generate. A few examples of REMI uses are: analysis of the economic impact of proposed expansion of the McCormick Convention Center in Chicago; analysis of proposed expansion of MASSPORT/Logan Airport in Boston; economic impact of expansion of Fort Drum in New York; several economic impact analyses of proposed highway expansion projects. Many uses are reported of REMI for general modeling of state or sub-state areas by state and sub-state government agencies to analyze an unidentified variety of state and sub-state programs. Finally, it should be stated that REMI will do analysis for clients, rent REMI programs to clients, or sell the model to clients. REMI has no control over modifications to the model made by clients in some of the above arrangements.

Many REMI applications appear to be entirely appropriate and may provide better analyses than any alternative model available. However, the description of REMI in the previous section implies that use of REMI to analyze economic impacts of proposed government investments leads to exaggerated estimates of projects' net public benefits. A typical economic impact analysis concludes that (x) jobs, (y) dollars of private income, and (z) dollars of state and local government tax revenues will be generated by the proposed

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project. These conclusions are generated by simulations with REMI that were described in the previous section. In project analysis, one simulation is done in the absence of the project and another in the presence of the project. REMI enables users to calculate multipliers, which are employment- or income-generated per dollar of government spending on the project. Typical income multipliers I have seen in economic impact analyses are between two and five. That means that each dollar of spending on the proposed project is projected to generate 2 to 5 dollars of additional income in the area included in the study. Income generated includes both income paid to workers and contractors on the project and also income generated by subsequent income recipients of subsequent rounds of spending. The multiplier process is precisely analogous to Keynesian multiplier analysis that appeared in macro texts some years ago. But REMI takes account of limitations on labor supply and of leakages outside the jurisdictions studied, which some Keynesian macro multiplier analyses did not do.

The exaggeration of public benefits of government projects in such REMI simulations stems precisely from the incomplete modeling of government sectors. If state and local government budget constraints were included in the model, REMI would recognize that increased government spending would entail increased taxes or other government fiscal alterations as indicated above. Then, increased spending by recipients of the increased government spending would have to be weighted against reduced spending by those whose taxes were increased or by reduced spending by recipients of government purchases that were cut in order to finance the project.

Obviously, all costs of a government project not financed by charges for use of the facility should be regarded as being financed by taxes with negative multiplier effects. It is often proposed to finance a government facility by taxes ostensibly levied on facility users—for example, a tax on hotel and restaurant bills in the vicinity of a proposed convention center. To the extent that such taxes are paid by convention center users, they are simply indirect charges for use of the facility and should be, but typically are not, added to user charges with the same assumed deterrent effect on use as direct user charges. In fact, such taxes are paid by all those who consume the taxed services, whether they use the proposed facility or not. To that extent, they are just one kind of tax levied on the population and have the same negative multiplier effect as any other tax to pay for the facility. More important, I have indicated in Mills (1991) that taxes ostensibly levied on facility users seldom cover more than a small fraction of facility costs. The remainder must be paid by usual

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taxes levied on local residents and businesses. It really does not matter whether other taxes are to be increased or other government expenditures are to be reduced to pay for the tax-financed part of a facility's cost. If other spending is to be reduced, it could have been reduced in the absence of the facility, so the facility requires taxes in excess of what they would need to be in the absence of the facility.

Finally, the analysis does not depend on whether the facility is bond financed or not. The present value of taxes needed to finance bond debt service, discounted at the government's borrowing rate, equals the sale price of the bond. If taxpayers' discount rates exceed the government borrowing rate then of course the present value of the debt service costs is less than the sale price of the bond, but the difference is not likely to be large.

An additional benefit is typically claimed in economic impact analyses of proposed government projects: the so-called outside money multiplier. A proposed convention center or domed stadium, for example, is assumed to draw patrons from outside the jurisdiction in which effects are being analyzed. It is undoubtedly true that many patrons of a large convention center or sports stadium come from outside the county or metropolitan area in which the center is located. Such patrons spend money in the jurisdiction but outside the facility on hotels, meals, etc. REMI is then used to trace the effects of such outside spending through the local economy, and multipliers are calculated that are precisely analogous to those calculated for spending on the project itself.

An unusually well documented example of distortions from regional impact analyses has been provided by the plans for a billion dollar expansion of McCormick place, Chicago's convention and exposition center. The consultant's economic impact study, KPMG Peat Marwick (1990), concluded that the outside money multiplier would result in a permanent net creation of 6,000 jobs. (Outside money multiplier jobs are permanent in that the outside money comes in each year. Construction multiplier jobs result from a one-time injection of construction money and disappear after the construction multiplier has worked itself out.) Virginia Carlson (1991) redid the calculations using all the consultant's assumptions except that she took account of jobs that would be displaced by the McCormick expansion and of the impact of local taxes that are to be levied to help finance the project. Her estimate is that the expansion of McCormick Place will result in a net loss of 348 jobs. She estimates that 3,335 jobs will be created by direct and indirect effects of outside money spent on the expanded convention center. The offsets are 2,799 jobs lost because of business displacement and 884 jobs lost

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because of negative multiplier effects of tax increases. No estimates are made by Carlson of revenues that will be raised by the increased taxes, but they are unlikely to raise more than enough to offset the center's operating losses. Capital costs must be financed in other ways. Interestingly, the Peat Marwick analysis was undertaken with a U.S. government model and Carlson's analysis was undertaken with REMI. Carlson predicts net job loss despite the absence of a government-balanced-budget equation in REMI.

The outside money multiplier has really nothing to do with the fact that the project is government-sponsored. Any local business activity that sells goods or services outside the local area—a pension management company or auto assembly plant, for example—brings precisely the same kinds of outside money benefits to the local area. In most kinds of private investments, state and local governments recognize this benefit and provide temporary and declining tax forgiveness, low interest loans, or other subsidies that are intended to stimulate investments in the private businesses. Convention centers and domed stadiums are no different and there is nothing in the modeling that indicates that government policies toward them should be different or that governments should own them. Visiting patrons to conventions or sporting events consume services that are exported from the local area just as is true of any other locally produced commodity or service that is sold to businesses or residents outside the local area. The fact that government produces the export good or service has nothing to do with the magnitude of the local benefit. The absence from the models of a cost side to government financing of the projects makes it appear that there are public benefits that are peculiar to government projects.

Of course, any increased outside money spending in a jurisdiction resulting from a government or private investment in the jurisdiction is precisely offset by decreased spending in other jurisdictions, other things equal. It is a zero-sum game. However, our federal political system produces state and local governments that, at best, represent narrow local interests. The zero-sum character of outside money multipliers should be taken into account in federal spending programs, but state and local government programs cannot be expected to do so.

Conclusion

The conclusion of this paper is that REMI and other regional models are frequently misused by state and local governments and their consultants in ways that patently exaggerate the benefits of

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proposed state and local government projects. By ignoring the need of state and local governments to raise money to finance capital costs of proposed projects, and by counting construction wages as benefits instead of costs, the models permit users to make it appear to the public that there are benefits to government projects that would not flow from similar private projects.

Such biased analysis cries out for explanation. Why do governments produce such patently exaggerated estimates of benefits of government projects? After all, the notion that state and local governments have budget constraints is not exactly an alien concept either to the public, to government officials or to scholars.

I simply throw out the following conjectures to stimulate thought. First, government officials like to promote big government. They benefit from large government roles in the economy. Adequate evidence is the observation that state and local governments resist cutting spending and, indeed, frequently raise taxes, in recessions when taxpayers' ability to pay has decreased. Second, to justify increased spending, government officials must identify some publicly desired goal to be accomplished by government spending. Creation of new jobs is among the best such goals that can be found. Third, they must make it plausible that government can accomplish the goal in a way that the private sector cannot. This is where REMI is so valuable. It is a complex computer model that lay people cannot understand or evaluate, and it has important scientific merits. Thus, the frequent government claim that the best scientific model available shows that x thousand jobs will be created by the project helps to carry the day. Finally, the inherent characteristics of the project help. A convention center can be claimed to improve the image of the city, and a domed stadium can be claimed to help keep the team in town.

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Bad Policy, Bad Law, and the Constitution: A Stiglerian View

Paul E. Godek

> The opinion that any monarch receiveth his power by covenant, that is to say, on condition, proceedeth from want of understanding this easy truth: that covenants being but words, and breath, have no force to oblige, contain, constrain, or protect any man, but what it has from the public sword.
>
> —Thomas Hobbes

Introduction

In a succinct demonstration of contempt for the notion that the Constitution has economic content, Supreme Court Justice Scalia stated that "a law can be both economic folly and constitutional."[1] The ghost of James Madison might have made a timely appearance and, if he had been prone to sarcasm, asked, "What do you think the Constitution is for—to protect the people from economic wisdom?" In any case, a majority of the Supreme Court agreed with Justice Scalia, and the particular decision was consistent with at least 50 years of precedent. Economic liberties have not been protected by the Supreme Court for some time. As for James Madison, a man can spin in his grave for only so long.

Justice Scalia is correct in one sense in assigning the word folly—implying error—to certain legislative action, but incorrect in another sense of the word. Similarly, in determining the proper scope for constitutional constraints on the legislature, the courts can also make two distinct types of error. So-called judicial activists favor one type

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The author is a Senior Economist with Economists Incorporated, Washington, D.C. George Stigler did not have an opportunity to comment on this paper before his death. I use his name in the title with deference. I have benefited from comments by Richard Epstein, Claire Friedland, John Lopatka, and Sam Peltzman. The opinions expressed are mine alone.

[1]CTS Corp. v. Dynamics Corp., 107 S. Ct. 1637, 1653 (1987) (Scalia, J., concurring).

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of error, judicial conservatives the other. It would seem that both do harm to the concept of constitutionally constrained government.

The study of constitutional protection of economic liberty or the lack thereof has received vigorous renewed attention from several scholars.[2] Applying George Stigler's view of regulation, I will examine how the legal issues relate to public policy. There is a compelling symmetry between the concepts of policy errors and judicial errors. When analyzing economic liberties and the Constitution, we should be careful not to overestimate the independence of the judiciary from political manipulation.

Two Types of Mistakes

In analyzing public policy, economists have two jobs. One is to understand and demonstrate which policy is most efficient, and the other is to understand and demonstrate why their policy recommendations are systematically ignored. As Stigler (1982: 8) presented this dilemma:

> Clever economists have displayed an obtuseness in this matter that is difficult to believe. They will say, not year after year but generation after generation, "Parliament, do you not realize that free trade would increase the national income?" As if the Parliament did not know this![3]

As with trade restrictions, the same may be said of agricultural subsidies, price controls, and convoluted tax codes. Such policies are economically inefficient, but they are politically efficient. They are crafted by clever people with the intent of subsidizing well-represented groups and taxing poorly-represented groups. A law usually accomplishes what was intended.

Another way to look at this is to recognize that economically inefficient policies involve two kinds of errors. The first kind of error we can call the simple mistake: the action that would not have been taken if more information about its consequences had been known. This is what most people think of when they use the term mistake.

[2]These books make fascinating reading for economists. See Bork (1990), Gwartney and Wagner (1988), Paul and Dickman (1988), Siegan (1987), Dorn and Manne (1987), Higgs (1987), Macedo (1986), Epstein (1985a), and Siegan (1980). Jan Tumlir (1985) discusses some of the same issues as they relate to protectionism and William Niskanen (1990) provides a helpful overview. In particular, Bork (1990), Epstein (1985a), and Siegan (1980) are excellent introductions to the subject. The reader may judge for himself whether the works of Epstein and Siegan stand up to Bork's criticism.

[3]There are those who will argue that the Parliament really does not know this, but that preaching to them is pointless anyway since they strongly prefer ignorance. The next three paragraphs follow the discussion in Stigler (1983).

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Mistakes of this type are not repeated and from these mistakes people learn. (Hence the economists' aphorism: there are no *ex ante* mistakes, only *ex post* mistakes.) Using this definition we see the sense in which it is peculiar to refer to agricultural subsidies or trade barriers as mistakes. Had such policies been mistakes, they would not have persisted over the decades in every western democracy.

Such policies are mistakes, however, in another sense of the word. This other sense of the word mistake is more encompassing. It implicitly compares the system that generates such policies with a theoretically better one: namely, a system that would not allow such policies to come into existence. Such policies are mistakes, not in the sense that legislatures will learn not to make them, but in the sense that legislatures should not have the power to implement them.

Stigler has suggested that these mistaken policies be referred to as "inappropriate," since "no generally accepted goal of society is achieved . . . the beneficiaries of such laws are achieving their goal, but the society as a whole is not achieving its goals" (1983: 19). Inappropriate policies are the mistakes that are repeated year after year. Once again, the alternative to this mistake is not a more competent legislature—the legislature is already too clever—but a more constrained legislature.

Justice Scalia, in his discussion of folly mentioned earlier, was referring to a purposeful corporate anti-takeover law passed by a state legislature: a law specifically designed to prevent the transfer of property, in order to protect incumbent management at shareholder expense. The lower court held the law to be in violation of the interstate commerce clause, a laudable device for constraining destructive legislation attempted by state legislatures.[4] Folly had little to do with it.

Economists refer to the distinction between the study of what does happen and the study of what should happen as positive versus normative analysis. When an economist analyzes, for example, rent control, he may examine the political economy of the policy, trying to explain why some cities have it and some do not. Alternatively, an economist may study how rent control affects the incentives of people who might otherwise have added to the stock of housing. In either case, he is likely to be well aware that the policy, now in its eighth decade since the Supreme Court legalized it, will not disappear if a copy of his insightful discussion is mailed to the New York City Housing Authority.[5]

[4]Dynamics Corp. v. CTS Corp., 794 F.2d 250 (7th Cir. 1986).

[5]See Epstein (1985a: 176–77) on Supreme Court decisions affecting rent control.

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Economists are also beginning to consider carefully the full costs to society of inappropriate policies. These rent-seeking activities do not destroy only small welfare loss triangles—the losses due to inefficient allocation of resources. Some or all of the rents that can potentially be transferred might also be compelled into the process of seeking or avoiding regulation. A government that has the power to selectively favor groups (with agricultural marketing orders or entry restrictions for automobile dealers, for examples), and has the power to selectively expropriate market surplus (windfall profits taxes or rent control, for examples), can destroy wealth without imposing any particular policies at all. The government can induce groups and industries to use resources to avoid regulation, as well as to be favored by regulation. The threat of regulation can destroy resources and distort economic incentives.[6]

Two Types of Judicial Error

We can present another dichotomy of mistakes, related to the distinctions drawn so far, in analyzing the judiciary.[7] So-called judicial activists find groups to be deserving of rights that are not provided for in the Constitution and that would not exist unless the government actively supplies them. Such rights might include welfare payments or housing of a certain quality. These findings confuse an opportunity with an outcome. Put another way, these findings confuse a right to be unhindered by the state with a right to be subsidized by the state. Judicial activists, it is said, have expanded the government's role inappropriately, simply by judicial fiat.

Judicial conservatives or passivists, on the other hand, recognize that in most instances the law does not, and the judiciary should not, require the legislature to act. But, at least in terms of civil rights—neither group protects economic liberties—judicial conservatives are less likely than judicial activists to find that the law constrains the legislature from acting. That is, judicial conservatives seem to give maximum discretion to the legislature, by requiring it to do less and by allowing it to do more.

[6]See Magee, et al. (1989), McChesney (1987), and Wenders (1987) for recent discussions on the potential costs of rent seeking and rent-transferring activity. Stephen Magee, et al. use the apt term "black-hole tariffs" to describe the limitless wastefulness of rent-transferrring activity. William Dougan (1991) offers an amusing and informative survey of this literature.

[7]Here, I will simplify the characterizations of so-called judicial activists and judicial conservatives. See Dorn and Manne (1987) for general discussions. My classification of judicial errors is, of course, not original. See Barnett (1987: 205–18), Siegan (1987), Anderson and Hill (1986), Scalia (1985), and Epstein (1985b).

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But the legislature can decide not to act without the judiciary's prompting. If the proper bounds of government encroachment upon civil or economic rights are determined more by the legislature or the executive, the judiciary serves a reduced constitutional purpose—except that it does less active harm. Those concerned about individual liberties might find the conservative approach as frightening, or more frightening, than the activist approach. The government's freedom from constraint comes at the expense of individual liberty.[8]

An appealing solution to these diverse approaches is for the courts to find that the government is not required to subsidize particular outcomes—by conferring upon those outcomes the status of rights—nor is the government allowed to contravene rights unless a specific duty or exemption is granted to the government under the Constitution. Bernard Siegan (1987: 81) states the position succinctly, "Failure to implement existing rights is no less an error than enforcing non-existent rights."[9]

Thus, in deciding on the appropriate role of the government, the judiciary can make two mistakes as well. It can require the legislature to act when it should not have required the action. We can call this an active mistake. On the other hand, it can allow the legislature to act when it should have constrained the action. We can call this a passive mistake. Judicial conservatives tend to make passive mistakes; they allow inappropriate policies. Judicial activists tend to make active mistakes, they require the inappropriate policy—although with regards to economic liberties they tend to make passive mistakes as well. The republic would be better served if each group recognized the error of its ways.

Economic Liberties

As noted above, the sanctioning of inappropriate economic policies by the judiciary has received renewed attention from legal scholars. They argue that a coherent interpretation of the Constitution should have protected such basic liberties as the freedom to sell a product or service at the price of one's own choosing, or the freedom to enter into otherwise legitimate businesses. They demonstrate, in the Madison-Hayek-Friedman tradition, the artificial and dangerous distinction now drawn by the courts between civil and economic liberties. Their simple thesis is one that will warm the hearts and

[8]For further elaboration of these themes, see Bork (1990), Macedo (1987: 111–36), Pilon (1987: 183–204), Macedo (1986), and Anderson and Hill (1986). Robert Bork argues that the greater threat to liberty comes from judicial activism.

[9]This position is sometimes referred to as principled judicial activism.

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stimulate the minds of many economists. It is that one of the purposes of the Constitution, and its creation of the judiciary, was to establish a form of government that eliminated the inappropriate policy. They argue that the system, to put it in modern jargon, was designed to disallow rent seeking.

But the protection of economic liberties did not survive. As these authors demonstrate, the Supreme Court began to abandon this role in the 1920s and 1930s, and it is showing no sign yet of reversing its direction (cf. Siegan 1980: chap. 6). The government is free to restrict property and contract rights without fear of judicial oversight. Property and contract rights have thus degenerated.

We are left with Stigler's challenge to explain why the judiciary changed its policy. As before, we should not rely on a "mistake" explanation of judicial behavior.[10] The concepts discussed here are, in theory at least, neither subtle nor complicated. The Court's action, persisting as it has, should be seen as purposeful. One way to begin is to ask to what extent did the Court actually change its policy. Since the Supreme Court could so easily revise its view of economic rights, those rights were tenuous to begin with. It may be more accurate to say that the Supreme Court provides a legal framework for regulatory confiscation and redistribution when political forces call for it.[11]

And such a result should not be unexpected. After all, in the long run, how independent is the judiciary? We have seen recently that the Senate carefully screens nominees to the Supreme Court. It is not likely to be in the President's interest to nominate candidates who will be rejected. Yet 27 out of 137 (about 20 percent) of those nominated to be either Associate Justices or Chief Justices of the Supreme Court have failed to win congressional approval.[12] The legislative and executive branches have also tried to manipulate the Court by changing the number of judges comprising it. Where there is wide scope for interpreting the Constitution, why should we suppose that judges approved by the Senate would make decisions inimical to the legislature's interest?

[10]As Stigler (1982: 8) put it, "To explain something by saying that it is a mistake . . . is on the same level as explaining it by intervention of invisible spirits."

[11]Landes and Posner (1975) develop this idea and offer a cogent analysis of the judiciary's role in the political process. They conclude that "in our view the courts do not enforce the moral laws or ideals of neutrality, justice, or fairness; they enforce the 'deals' made by effective interest groups with earlier legislatures" (1975: 894). The authors cited in footnote 2 offer many descriptions and insights regarding the political manipulation of the Supreme Court.

[12] See *World Almanach and Book of Facts* (1991: 89), and *Wall Street Journal*, 26 October 1987: A 23.

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Recent Supreme Court nomination hearings have shown there to be a close match between political parties and judicial types. Since judges are selected and approved through a political process, it should be no surprise that the predilections of successful judges will resemble those of the political parties. Judges tend to be either activists or conservatives because politicians tend to be either Democrats or Republicans. We get the choices of judges we do because we have the choices of politicians we have. That is not a comforting thought.

Conclusion

As with civil liberties, basic economic liberties could be protected, if at all, only by an independent judiciary. Attempts to enjoin such liberties are rational, calculated, and determined methods of enhancing the positions of special interests. The legislature is incapable of constraining itself from such redistribution; indeed it is designed for such redistribution. As Jan Tumlir (1985: 16) described the process:

> The result of the loosening of legislative constraints can best be described as a refeudalization of the economy. The notion that groups have rights is medieval. In a democracy, groups may have political influence, even a degree of economic power, but only persons have rights. In the redistributive state, government has become what it was in the middle ages—an inscrutable power above the people, to be lobbied, petitioned, and propitiated for the favors it can dispense.

In the United States, basic economic rights were considered to be protected by judicial oversight at one time. That may have been the case largely because the effective political demand for such regulation did not exist prior to the 1920s. To resurrect economic liberties and place them under constitutional protection is an honorable goal. Whether or not it is a realistic goal remains to be seen.

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Barristers and Barriers: Sir Edward Coke and the Regulation of Trade

Gary M. Anderson and Robert D. Tollison

Introduction

Sir Edward Coke (1552–1634) has long been acclaimed as a key figure in the emergence of the modern free-market economy in England. During a long career in which he was successively Attorney General (1594–1606), Chief Justice of the court of Common Pleas (1606–1613), Chief Justice of the Court of King's Bench (1613–1616), and from 1620 leader of the Parliamentary opposition to the king in the House of Commons, many historians have interpreted Coke as having been a significant force behind deregulation of the English economy, most notably through his role as leading opponent of royal grants of monopoly rights to favored individuals. Modern scholars generally agree that Coke was primarily motivated by his philosophical commitment to the rule of law—not to a vision of free trade so much as to his belief in the majestic rationality of the common law, of which he was a leading practitioner for most of his adult life.

Previous writers have tended to accept Coke's stated views at face value, and have usually ignored the impact that the implementation of these views as actual public policy had on Coke's own professional position, or on the wealth of the professional interest group—the practitioners of the common law, the barristers—of which he was a leading member. Our purpose in the present paper is to redress this neglect.

In early modern England, judicial services were provided in a competitive market, in which a variety of different courts and court systems, operating according to different sets of legal principles and

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precedents, adjudicated disputes.[1] Most of these judges received most of their income not from salaries paid by the king or Parliament, but from the fees they charged litigants for the use of their courts. Although there were many restrictions imposed by the English state on the operation of this competitive market—for example, most courts had legally defined boundaries beyond which their decisions were not supposed to apply—as a practical matter, different courts were often in direct competition for the same potential litigants.

Beginning in the late 16th century, the court system based on the English common law had begun to achieve clear dominance in the market for judicial services by erecting various legal entry barriers which hampered the ability of other court systems to successfully compete. The three common law courts—Common Pleas, King's Bench, and the Exchequer—colluded together, and generated substantial rents for the privileged barristers.

Expansion of the monopoly jurisdiction of the common law courts tended to increase the net rents received by barristers and judges. Sir Edward Coke was the single most effective leader of this expansion of the common law jurisdiction by means of restricting the activities of competing courts. The opponent of royal grants of monopoly privileges was a vigorous defender of monopoly privileges in his own bailiwick.

The paper is organized as follows. We first discuss the market for adjudication services in early modern England, describe the organization and operation of the common law courts, and explain how those courts emerged as a kind of law cartel. We next consider the implications of Coke's supposedly deregulatory agenda for the economic interests of the barristers, himself included. Coke's activities in pursuit of an expanded monopoly jurisdiction for the common law are then outlined. We proceed to analyze the actual economic substance of the case for Coke as an "opponent of monopoly." A final section summarizes and concludes our argument.

Barriers and Barristers

There were three common law courts, which all used the same body of legal precedents and procedure, but had different basic jurisdictions. The court of Common Pleas had jurisdiction over legal

[1]In addition to the common law courts, there were the court of Chancery, the courts of the law merchant, the Admiralty court, the court of the Constable and Marshal, the Ecclesiastical courts, the Council, the House of Lords, the courts held by the Justices of the Peace, the various Franchise courts, and many others. For a detailed overview of this bewildering array of competing courts, see Holdsworth (1956).

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actions between individual subjects of the Crown, i.e., handled the bulk of ordinary law suits; the court of King's Bench had jurisdiction over crimes, and functioned as a kind of appeals court in that decisions made in Common Pleas could sometimes be appealed there; and the court of the Exchequer had a jurisdiction which largely limited its activities to cases involving government revenues (e.g., tax cases).

These three common law courts operated as a cartel, with each court in effect assigned a particular general jurisdiction. However, as is normal in the case of such collusive agreements, this cartel arrangement was imperfectly enforced, and competition between the different courts frequently arose at the margin of respective jurisdictions.[2] William Holdsworth observes (1945: 238) that when the expected fee income made such activity seem potentially profitable to the judges of one of the courts, they "grasped at any kind of jurisdiction [they] could obtain."[3]

Common law judges were selected from the ranks of barristers, lawyers called to the bar and allowed to practice in common law courts. In 1600, there were approximately 2,000 barristers (Levack 1973: 3). However, this number reflected the outcome of strict legal limits on entry of potential barristers. Practice before the bar of the common law was highly restricted.

Entry into the practice of the common law was reserved to members of the Inns of Court. A Royal Proclamation of 1546 made Inn membership necessary before litigants could plead in Chancery, and Star Chamber, courts in addition to the common law courts. Thus,

[2]Holdsworth (1956: 196) quotes Bracton as noting that "the special competence of each court is only vaguely defined," and in fact the courts often competed with one another for certain kinds of cases. The sometimes vigorous competition between the three courts was facilitated by the use of "legal fictions" of various kinds. For example, if a court's technical jurisdiction was limited to cases involving certain specified circumstances, that court could simply redefine the actual circumstances applying in a particular case so that its jurisdiction seemed to apply; the mere act of fictional redefinition sometimes was sufficient to obtain the business the case represented (Holdsworth 1956: 119–220).

[3]Throughout the Middle Ages in England, until the later 19th century, the principal source of judges' income was not salary (which tended to be small), but fees charged for judicial services by litigants. Rather than public employees, judges were the "owners" of their judicial offices, who "rented" their services at market prices. Technically, judgeships were not "saleable freeholds," i.e., such positions could not be openly bought and sold for cash; but nevertheless the judges were residual claimants to the value of their court's output (Holdsworth 1956: 252). This, incidentally, was the rule rather than the exception among government officials generally until quite recently; in the Middle Ages, almost all government officials of all types were entirely paid out of fees they charged for their services (see Webber and Wildavsky 1986).

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Inn members had the exclusive right to practice law in all important English courts except Admiralty and the Ecclesiastical courts. From about 1600, seven-years membership, in effect, apprenticeship, in one of the Inns was required, to be followed by the performance of learning exercises for a period of three years after receiving the call to the bar. Residency was required for the period of membership; although this rule was sometimes loosely enforced, after 1596 enforcement was fairly strong (Holdsworth 1945: 264).

Life at any of the Inns of Court was subject to an extremely detailed, and tightly enforced set of social regulations (Holdsworth 1945: 264). A primary function of these regulations was to prevent residents from offering legal advice to clients prior to the call to the bar. Some regulations continued to apply to barristers throughout their careers. For example, if after being called to the bar, one member brought an action against another member, the offender was fined; and a member of an Inn was forbidden from appearing professionally in court against a bencher (Holdsworth 1945: 269). The administration of the Inns was controlled by common law judges, who issued extremely detailed instructions about Inn regulations and policy. Sitting judges ordered election of students to the judicial bench, strongly influenced who did (and who did not) receive a call to the bar, and frequently intervened in Inn admission decisions ((Holdsworth 1945: 269). In addition, common law judges erected a considerable variety of entry barriers which restricted competition amongst barristers (Prest 1986: 13). In 1614, the judges sought to impose a fixed, annual quota on calls to the bar. Entry of new barristers into the common law practice was tightly restricted.

Coke was a dedicated, in fact pugnacious, defender of these rent-generating entry barriers which protected barristers from competition. He consistently worked to expand the jurisdiction of the common law and the privileges of barristers, while simultaneously restricting the jurisdiction of other courts and impeding the activities of non-barrister lawyers.[4] One of his principal interests throughout his writings concerned strengthening jurisdictional boundaries between courts, supposedly because absence of such clear boundaries led to "excessive" and more costly lawsuits—although without explaining how this counter-intuitive result could come to pass (White 1979: 50). He led the fight to limit the fees charged by lawyers

[4]Incidentally, while non-barristers were prevented from practicing in common law courts, the reverse was not true; both barristers and common law benchers could legally practice in non-common law courts, but usually did not simply because the fees available tended to be lower (Prest 1986: 265).

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in the Chancery court, which would have restricted the ability of that jurisdiction from competing with the common law (White 1979: 61–62). He fought to restrict the Chancery jurisdiction directly as well as other non-common law courts; these efforts were ultimately unsuccessful. Coke also worked to limit entry into the Inns of Court, although the effect of this effort seems to be unclear (Malament 1967: 1324).

Returns available to barristers were potentially very high. Most competent barristers could expect to earn at least 600 pounds sterling per year, "an excellent salary in the seventeenth century" (Richardson 1975: 488). Many barristers became extremely wealthy as the result of their legal practices; Coke himself was one of the richest, and is described by one historian as having been "fabulously wealthy" (Prest 1986: 155). After his death, Coke left a bequest of 99 separate estates (Malament 1967: 1324).

Competition for Jurisdictional Rents

The barristers and the common law judiciary did not have a monopoly over legal disputes in early 17th-century England. As we noted above, the common law faced competition from a variety of other court systems, whose jurisdictions overlapped at the margin.

Court of Admiralty

The most significant area of jurisdictional overlap occurred with the Admiralty law. By the early 17th century, this body of law had begun to attract large numbers of commercial litigants, who increasingly preferred its more efficient procedures to the relatively cumbersome operations of the common law courts. One of the most interesting, albeit neglected, aspects of Coke's activities concerned the relationship between the common law courts and the court of Admiralty. Therefore, a brief digression outlining the history and functioning of this jurisdiction is in order.

The law of Admiralty began as the rulings of local port courts which arose by the 14th century in order to adjudicate disputes involving issues arising from maritime trading activities. Given the poor transportation and communications systems, and the importance of specialized knowledge of maritime trading activities required for efficient adjudication in such disputes, this early development was straightforward. These local courts were eventually superseded in the 15th century by a system of central courts established by the king called the High Court of Admiralty (Holdsworth 1956: 549); this system grew rapidly until by the mid-16th century

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it had begun to handle most cases involving contracts made at sea, or which stipulated delivery in a foreign country.[5]

The period beginning in the early 16th century saw a massive expansion in the value of foreign trade for England. International commerce was growing rapidly, and maritime trade generated an increasingly large fraction of the total demand for adjudication of legal disputes. The concession to hear cases involving maritime disputes was consequently very lucrative.

Throughout the 16th century, the Admiralty courts began to acquire an increasing share of litigation business resulting from this expansion of trade. Merchants and mariners preferred Admiralty courts because their "civilian" lawyers tended to be more competent in maritime law, and the courts followed legal procedure very similar to that employed on the Continent (thus facilitating the resolution of disputes involving Continental individuals and their lawyers). Further, the Admiralty court could sit at any time, and was not restricted by the peculiar, convoluted legal calendar followed by common law courts; consequently, important business was never delayed until the following term. Finally, Admiralty courts did not use juries; instead, judges controlled the entire proceeding, delivered the verdict, and determined penalties. These judges usually had a high level of expertise in the subject areas of typical litigation, and often had a better understanding of the real issues at dispute than would untrained and often poorly-educated jury members (see Levack 1973: 155). In short, the Admiralty court was able to provide superior service to certain litigants, who therefore transferred their business from the common law courts. According to Holdsworth (1945: 259, 284), by the end of the 16th century the common law had begun to experience a significant drop in litigation business as a result, and this decline was amply justified by the common law's various defects.

The common law courts benefited from litigation transferred to their jurisdiction for elementary financial reasons: they were losing substantial revenues to the Admiralty court. For example, the court received 14 pounds sterling, on average, per writ in the early decades

[5]The jurisdiction of the Admiralty courts, as laid down by royal proclamation, was divided into two major sections. The first, cases involving prizes seized at sea during time of war, was fairly minor in extent and scope. The other major section was termed the "ordinary" jurisdiction. This was in turn divided into three portions. First was the Admiralty Droits, fixed percentages of the value of goods taken from pirates, and/or marine salvage, as determined by the Crown. Of greater importance were the other two portions, criminal cases, and civil cases, involving maritime activities. See Holdsworth (1956: 544ff.).

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of the 17th century (Levack 1973: 74). Legal fees paid to barristers were frequently higher than this.

In 1575, the common law courts entered into a kind of provisional agreement—i.e., a kind of truce—with the Admiralty courts, in which each system recognized the commercial jurisdiction of the other. In effect, this provisional agreement was an agreement to collude, in which both court systems avoided competing with each other for cases at the margin of their respective jurisdictions. However, in 1606, Coke—in one of his first acts as Chief Justice of Common Pleas—expressly repudiated this agreement (Holdsworth 1956: 553). Coke denied that the Admiralty was a court of record, and that those judges had the power to compel appearance, which in turn meant that the courts had no legal recourse in the event that a witness, or even a defendant, simply refused to appear after being summoned. He also denied that the Admiralty had the legal right to compel acquiescence to its judgements, and denied the jurisdiction of the Admiralty court over any contracts made on land, including those stipulating performance of the contract at sea. The ruling implied that virtually all contracts actually adjudicated in Admiralty courts were contracts over which those courts had no legal competence, thus leaving almost nothing of the "ordinary" jurisdiction of the Admiralty courts; this meant prize jurisdiction was left for the common law courts, a fact that Coke does not appear to have commented on.

True to form, Coke did not stop with the claim that the Admiralty courts did not possess legal jurisdiction over the commercial, and criminal, cases they were increasingly adjudicating. He went further, and insisted that the common law courts were the appropriate venue for all such cases. The contracts made on land virtually all fell within Coke's interpretation of the common law jurisdiction. Moreover, even contracts made overseas (and offenses committed abroad) were claimed by the common law courts to be within their exclusive jurisdiction. As mentioned earlier, this legalistic expropriation operated by use of "legal fictions," which redefined the location of the claim or dispute. For example, assume that a particular contract was drawn up in Marseilles. As such, it clearly fell within the Admiralty court's jurisdiction as assigned by the king. But the common law courts could legally claim jurisdiction and proceed to try the case as long as they first defined "Marseilles" as being a place in England. Incredibly, this arbitrary fiction worked; in fact, in one such case, Marseilles in France was simply claimed to represent "Marseilles in Kent," and jurisdiction over a contract for delivery overseas was claimed by the court of Common Pleas and lost by the Admiralty

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courts (see Levack 1973: 78). The use of such legal fictions was a common occurrence (see Bourguignon 1977: 12).

Another important technique used by the common law courts, implemented aggressively by Coke, was the prohibition. This was a judicial ruling that literally prohibited another, "inferior" court from proceeding to hear a particular case, on the grounds that the case in question was outside that court's legal jurisdiction. In the 1590s common law judges began a "full scale attack" on the so-called inferior courts, using this technique (Levack 1973: 73). The common law courts issued writs of prohibition against Admiralty courts especially to prevent the latter from hearing cases of contracts entered into abroad, or in English ports; with Coke as Chief Justice, such writs became "frequent" (Bourguignon 1977: 12–13). The major effect of prohibitions was in their potential to establish jurisdiction-limiting precedents, that would bar certain categories of cases altogether from future hearing in the prohibited court (Levack 1973: 76). By the later half of the 17th century, the Admiralty court's "instance," or commercial, jurisdiction had been highly restricted—to the benefit of the common law courts (Levack 1973: 76). These legal shenanigans imposed costly delays in court, and even occasioned diplomatic difficulties when foreign litigants were affected.[6] (Admiralty courts frequently tried cases in which foreign nationals were directly involved.) Such delays were often exploited by unscrupulous litigants; as Holdsworth writes (quoting a biography of a contemporary), "[not] one cause in ten comes before the [Admiralty] court but some of the parties or witnesses in it are pressing to go to sea with the next tide" (1956: 555). Gradually, litigants began to abandon the Admiralty court in favor of the (prohibition-issuing) common law courts; over the course of the 17th century, Parliament supported the common law over its rivals, while the monarch tacitly accepted the outcome of the jurisdictional dispute. By mid-century, the once thriving civil jurisdiction of the Admiralty had been sharply curtailed.

Merchant Courts and Ecclesiastical Courts

Another jurisdictional dispute prosecuted by Coke involved the law merchant. This was a special body of commercial law administered in merchant courts, which had emerged in the Middle Ages, and continued to appeal to many merchant-litigants despite its gradual decline in Tudor times. This form of law primarily involved

[6]For example, Holdsworth (1956: 555, n. 1) cites a complaint by the Spanish Ambassador about the delays in Admiralty, caused by prohibitions, affecting Spanish nationals.

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judgments by private arbitration. In 1606, Coke, then Chief Justice of Common Pleas, ruled that the law merchant was actually part of the common law, and that the decisions of merchant courts could be reversed by common law courts (Benson 1990: 61). Bruce Benson quotes Leon Trakman, a recent authority on the law merchant, as concluding that as a result "merchant courts. . .were abolished, or alternatively, they were integrated into the common law system." During the 17th century, "the internal trade of [England] was regulated by a common law. . .and not by a separate Law Merchant" (Holdsworth 1956: 569).

Coke also was a leader of the common law opposition to the Ecclesiastical courts, which in addition to cases involving strictly religious matters had jurisdiction over matrimonial and testamentary cases. This latter jurisdiction was a lucrative source of legal fees, and the Ecclesiastical courts, particularly the court of High Commission, were depriving the common law courts of this litigation business. In the 1590s, the common law courts began a "determined attack" (Levack 1973: 79) on these competitors, by means of the issuance of writs of prohibition, as had been done with the Admirality courts. Although this campaign was not initiated by Coke, he played a prominent role while Chief Justice; writs of prohibition against the ecclesiastical jurisdiction increased markedly during his tenure (Eusden 1968: 89) and "cripple[d] the jurisdiction of the ecclesiastical courts" (Holdsworth 1956: 629).[7]

Regulation, Rent Seeking, and Suit Seeking

The common law has often been interpreted as having been a source of consistent opposition to governmental restrictions on free competition. This traditional view, however, is very misleading. The common law courts consistently fought for the privilege to allocate monopoly rents to be granted to the common law courts. Coke was a leader of this effort. Finally, the common lawyers achieved a successful alliance with Parliament, and together those two groups sought and obtained a legal monopoly in the granting of monopoly privileges. We will proceed to review the facts of this strange, and neglected episode in the history of rent seeking.

[7]According to the same source, Coke did not limit his activities to restricting the ecclesiastical courts' non-religious jurisdiction. Coke argued that if spiritual goods were sold (e.g., tithes) they became temporal goods and thus subject to the common law. If a parishioner was enjoined to make pecuniary, instead of corporal, penance, any consequent action must also be taken to a common law court. Eusden maintains that Coke distorted the interpretation of precedents in his effort to limit the ecclesiastical jurisdiction, using "biased and exaggerated" reasoning (1958: 92).

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By the mid-16th century, the central government of England began to enact a wide array of legal restraints on free trade. Both the king and Parliament generated these market restrictions. The main difference between the regulations promulgated by the two branches of government was that the monarch tended to issue grants of monopoly privileges, or "patents of monopoly," to specific individuals, whereas Parliament produced numerous legal entry barriers which restricted competition in specific markets.

Eli Heckscher and other economic historians have tended to emphasize royal grants of monopoly as the prime examples of domestic restrictions on competition. But many important sources of restriction rent were parliamentary in origin. For example, regulated and chartered companies gradually came under parliamentary control, although most had originally secured royal sanction (Holdsworth 1945: 320). Most important, economic regulation was statutory in nature, and enacted by Parliament. For example, consider the following parliamentary acts which were in force during the early 17th century (as discussed in Elton 1986: 231–50). Domestic trade in grain was licensed; the prices of beer barrels were fixed; alehouses were licensed, inns were restricted, the number of taverns in towns was strictly limited, and their prices were fixed; the highly detailed Clothmaking Act of 1552 fixed standards of quality and specified regulations for the cloth industry; a 1581 law controlled the quality of wax; and a 1581 law prohibited iron-making within 22 miles of London. There were many other such statutory regulations.[8]

Moreover, although some older historians imply that such parliamentary regulation was aimed at promoting the "public interest," supposedly unlike the purely venal royal grants of monopoly, rent seeking by particular interest groups who expected to benefit from the passage of many such regulations was quite blatant and overt.[9]

[8]In addition to these various and sundry domestic regulations, Parliament passed numerous restrictions on foreign trade, such as the law which made it a felony to carry leather out of the country, a prohibition on the export of sheepskins and buckskins, a prohibition on the importation of gloves, girdles, knives, daggers, scabbards, pins, and points, and even a law which made it a crime for a traveler to take his own horse abroad for personal use (Elton 1986: 234, 247–48, 255).

[9] See for example Holdsworth (1945, and elsewhere). Strangely, Holdsworth himself provides a long list of examples of overt rent seeking behind legislated regulations. English pewterers lobbied for a law prohibiting the sale of imported pewter; hatters did the same to restrict competition from imported hats; manufacturers of leather goods were granted the exclusive privilege of purchasing raw leather; and cappers succeeded in convincing Parliament to pass a law requiring the wearing of woolen caps on Sundays and holidays (Holdsworth 1945: 335). Amazingly, after listing these and other examples of blatant rent seeking, Holdsworth concludes that such legislation nevertheless "served to promote trade," (ibid.) and thus promoted the public interest.

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Historians since David Hume have honored Sir Edward Coke as a key defender of liberty against royal tyranny. A number of prominent economic historians have described Coke as having played a leading role in the fight against monopoly grants in the early 17th century. Ephraim Lipson (1956), Eli Heckscher (1955), John Nef (1968), Donald Wagner (1935, 1937), and Bruce Yandle (1993) all argue that Coke was an early advocate of *laissez faire*, and link his views to the later writings of the classical economists. Although more recent economists agree that Coke was indeed a major force behind the deregulation of the 17th-century economy, some of them have treated these claims with greater skepticism. Still, even they maintain that Coke was principally motivated by his philosophical commitments to the dominance of the common law.

But, neither Coke nor any of his fellow barristers opposed government economic regulations of the competitive process in principle. In fact, the common law courts consistently supported parliamentary regulation of all sorts. On several occasions, the courts even extended the coverage of parliamentary regulations. Although Coke often railed against monopolies, he specifically approved of statutory, i.e., legislative, restraints on trade (White 1979: 123).[10] According to Coke "liberty of trade" could lawfully be restricted by "common consent," i.e., all parliamentary regulations, no matter how anticompetitive, were by definition lawful (White 1979: 122). Coke was also a strong proponent of the full panoply of mercantilist restrictions on foreign trade; by Tudor times, the bulk of such restrictions were statutory in origin (White 1979: 138).

This pattern of support for governmental restrictions on free competition was consistent with the economic interests of barristers in general. Practitioners of the common law were beneficiaries of government economic regulations for several reasons. According to Wilfrid Prest, "[virtually] every major political, economic, and social development in Tudor and early Stuart England helped make more work for common lawyers in general, and barristers in particular" (1986: 49). This effect took several different forms.

When alleged violators of economic regulations were tried in court, barristers were employed by the defense, the prosecution, and provided the judge or judges. For example, cases brought under the

[10]The term "monopoly" was used inconsistently by contemporaries, including Coke; by use of the term, he normally meant to refer only to royal grants of exclusive privileges to specific individuals. In the course of debate over the bill to restrain monopolies in 1621, it was apparent that members of the House of Commons meant a variety of different things by the term "monopoly," none of which included the notion of legal entry barriers (White 1979: 129).

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Elizabethan Statute of Apprentices were normally tried in the court of King's (or Queen's) Bench, where all legal counsel were barristers, or in the court of the Exchequer, in which most legal counsel were barristers. Between 1563 and 1603, these two courts tried at least 360 such cases, counting only cases brought by informers (Davies 1956: 48). Each such case generated fees not only for the legal counsel on both sides, but for the various court officials (e.g., the judge, the bailiff, the clerk, etc.).

The rapid growth of paternalistic state regulation during Tudor times was a strong source of demand for the services of barristers. For example, the proliferation of grants of monopoly—issued by both the monarch, and by Parliament—led to the demand on the part of both monopolists and potential entrants for the services of barristers during court challenges (Prest 1986: 298). Even bringing a single motion, no matter how inconsequential, at the common law bar required a payment to a barrister of between 10 and 20 shillings (Prest 1986: 162).

The most important officials responsible for enforcement of domestic economic regulation in Tudor and Stuart England were the justices of the peace (JPs). These men were the "agents of unified industrial legislation" (Heckscher 1955: 246); they fixed wages under the Statute of Apprentices, enforced detailed industrial regulations, and even operated a system of courts for this purpose (see Holdsworth 1956).

Royal grants of monopoly to specific firms were not a primary source of demand for the services of JPs. Owners of monopoly privileges had a strong incentive to bring suits against interloping competitors in courts of law, and the policing activities of JPs were therefore unnecessary. On the other hand, parliamentary regulations like the Statute of Apprentices, which imposed detailed regulations over a large sector of the economy, required massive enforcement efforts to be effective. Enforcing such broad statutory regulations occupied a large proportion of the JPs' time and efforts. The JPs were responsible for fixing and enforcing wage maximums under that Statute, and also the wage minimums required under the Woolens Act of 1604 (Holdsworth 1945: 382; Lipson 1956: 254).

Many of these important officials, whose jobs depended on the proliferation of statutory restrictions on market exchange, were either barristers or members of one of the Inns of Court. One survey of JP commissions from six counties indicated that in 1636, 21 percent were barristers or serjeants (cited by Prest 1986: 237); another report for 1608 (Gleason 1969: 87) finds that 175 of 311 total JPs (i.e., over

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56 percent) had been admitted to a common law Inn of Court.[11] Moreover, the barrister justices appear to have been especially diligent and industrious in their regulatory enforcement activities, so that their actual influence was probably greater than their relative numbers indicate (Prest 1986: 238).

A principal form of economic regulation in Coke's time involved the myriad, often excruciatingly detailed restrictions on market competition imposed by towns and municipalities, thus creating municipal "corporations." Barristers were hired by these corporations to defend their privileges from "interlopers" in court, and they required the services of the common law courts for such prosecutions. The rapid expansion of government economic regulation, at both the national and the local levels, during the Tudor era generated increased litigation business for the common law (see Prest 1986: 242).

There was another, more direct, reason for practitioners of the common law to favor parliamentary over royal forms of economic regulation; barristers were responsible for designing and enacting many of the legislative controls. By the time of Henry VI, between one-quarter and one-fifth of the House of Commons were lawyers, and this continued to reflect the approximate proportion in Coke's time (Prest 1986: 254). Barrister-MPs tended to dominate the design and drafting of legislation by virtue of their legal expertise. A seat in the Commons produced additional benefits for lawyers in the form of contacts and connections which led to increased business in their law practices; many members of Parliament who were also barristers continued to plead at bar even while the Parliament was actually in session (Prest 1986: 255). In addition to the number of barristers who actually held seats in Parliament, legislative activity tended to benefit many other barristers whose services were required in various legislative support roles.

Finally, some common lawyers had investments in regulated, or monopoly, companies. Barristers were prominent "projectors" in overseas trading and colonizing companies, mining ventures, fen-draining enterprises, and various other speculative investments (Prest 1986: 20). Such individuals could expect to receive increased profits on their investment if their firms received protection from potential competing entrants. While barrister-investors had no special reason to favor parliamentary as opposed to royal grants of special

[11]Of these 175, 48 had actually been "called to the Bar" (Gleason 1969: 87). The rest either had yet to receive such a call, or had for some reason chosen not to pursue careers as barristers.

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privileges, such grants became increasingly the province of Parliament in the early 1600s.

Coke, Parliament, and the Reallocation of Political Rents

For purposes of evaluating the effect of the common law courts in general, and Coke in particular, on the deregulation of trade in early 17th-century England, two major events stand out; the first being a court decision, and the second being a Parliamentary statute. Neither event represented the clear victory for free trade some scholars have claimed; but both events were clear victories for the economic interests of barristers.

The *Darcy v. Allen* case (1603) has received much attention as the opening shot in the campaign against monopoly grants purportedly initiated by the common law. The basic outline of this "Case of Monopolies" is familiar. Darcy held a royal monopoly grant to the importation of playing cards. Allen imported cards without asking Darcy for permission. Darcy sued Allen, and the court ruled that the monopoly grant was invalid.[12]

Since Coke wrote about this ruling, and placed great emphasis on its fundamental importance, some writers leave the impression that Coke was somehow partially responsible for this supposed challenge to monopoly grants.[13] But in fact, Coke was the Attorney General at the time, and was obliged to *defend* the contested patent in court, which he did.

Moreover, the ruling itself simply did not claim all monopoly grants to be invalid. It only stated that trade must be left free *except* for "definite restrictions known to and recognized by common law" (Holdsworth 1945: 350).[14] The common law recognized a bewildering array of restrictions on free trade, which shared no common thread in any economic sense. According to Barbara Malament (1967: 1354), Coke "again and again. . . distinguished between trade

[12]For a detailed account of the case, see Donald (1961: 208–49); Pound and Plucknett (1927: 184–85) provide a short sketch of the essentials.

[13]For example, Hayek (1960: 168) discusses Coke's later account of the *Darcy* case, but fails to note that Coke was the lawyer for the monopolist plaintiff.

[14]The *Darcy* decision defined a monopoly to mean cases in which price had risen excessively, quality had fallen, and skilled artisans had become unemployed—the decision made no reference to monopoly in the sense of legal privileges to a sole proprietor (Holdsworth 1945: 349ff.).

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regulation and trade restriction" and provides numerous examples for this entirely arbitrary distinction-without-a-difference.[15]

The very nature of the *Darcy v. Allen* case bears on a related issue. Darcy had received a monopoly privilege to violate a previously existing parliamentary ban (3 Edward IV. c. 4) on the importation of playing cards. According to Coke's later account, the court decided that a dispensation of this kind "wholly defeated the aim of the statute [and] was 'utterly against law' " (Holdsworth 1945: 358). The 1603 court decision repudiated the Crown's right to issue such an exemption, so the outcome was that neither Darcy nor anyone else had a legal right to import playing cards.[16]

This most peculiar feature of the 17th-century monopoly debate has been generally ignored: the common law jurists were adamantly opposed to royal grants of monopoly *dispensation* to parliamentary regulations. Many royal "patents of monopoly" were just grants of exemption to specific individuals from legislated restrictions on markets.[17] The existence of such loop-holes reduced the value of trade barriers produced by Parliament from the standpoint of their rent-seeking beneficiaries. However, most such dispensations surely enhanced economic efficiency, and made a greater variety of goods available to consumers at lower prices. Nevertheless, in the case of the Penal Statutes (1605), the judges declared that such royal dispensations were the "scandal of justice and the offence of many" (Holdsworth 1945: 359). Although the issuance of such royal dispensations did not end until after the enactment of the Statute of Monopolies (see below), their use declined following the 1605 ruling.

Coke has a more valid claim to another key event in 17th-century monopoly policy. In 1624, Parliament enacted the Statute of

[15]During the *Darcy* proceedings, Coke asserted that "The customary rights and ordinances of the cities and corporations are legal although they oppose the common law and the liberty of the subject"; and previously, while speaking in Parliament, he said that "If Her Majesty makes a Patent or a Monopoly to any of Her Servants, That we must go and cry out against; But if she grants it to a Number of Burgesses or a Corporation, that must stand; and that, forsooth, is no Monopoly" (quoted in Heckscher 1955: 287).

[16]However, Parliament subsequently awarded a similar monopoly dispensation to import playing cards to another party, the Company of Card Players (Malament 1967: 1351). When Parliament itself decided to issue dispensations from parliamentary statutes, it encountered no objections from the common law.

[17]For example, a royal patent allowed the Merchant Adventurers to import cloth, contrary to a law banning such imports; a group of French citizens were permitted by the King to import caps in spite of the statute prohibiting such trade; and a royal dispensation allowed the curriers to manufacture leather goods, contrary to another restrictive statute (Holdsworth 1945: 358, n. 5). In 1619, King James I even set up, for a fee, a special corporation which was awarded a monopoly grant to sell dispensations to individuals from the Statute of Apprentices (Lipson 1956: 284–85).

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Monopolies (21 James I, C. 3), a sweeping reform bill that severely restricted the ability of the Crown to issue monopoly grants to favored individuals. This bill was principally drafted by Coke, who at the time was the leader in the Commons of the opposition to the king; Coke had also previously chaired the Committee for Grievances, which laid the political groundwork for the legislation.[18] Malament maintains that "the statute did very nearly embody Coke's views at the most radical stage of his career" (1967: 1351). Joan Thirsk, another recent writer concludes that the statute "strengthened the tide flowing in favour of free trade and free industrial growth" (1978: 100). Coke's involvement with this legislation constitutes his primary claim to actual economic reforms.

The statute which resulted failed to eliminate monopolies, but radically altered the political production of future legal entry barriers. Section 1 of the statute seemed to void all institutions granting exclusive control of any product. A number of industries were expressly allowed to continue as monopolies, including saltpeter, gunpowder and various other products "deemed essential to the realm." New production processes, old production processes new to England, companies with exclusive trading privileges, and city corporations were permitted to retain restrictions on competition within their boundaries.[19] Holdsworth (1945: 355) comments that the privileges of chartered companies, craft guilds, and boroughs "were recognized by the common law, and saved by the Act of 1624."[20]

Further, parliamentary regulations were automatically exempt, regardless of the effect they might have on market competition. This was the most important feature of the statute, and reflected its primary

[18]Coke largely wrote the original bill in 1621 that was "substantially identical" to the Act actually enacted in 1624 (see Zaller (1971: 130).

[19]And these city corporations also granted monopolies to favored individuals, which monopolies were exempt from the Statute, too. Usually, these monopoly grants were ostensibly aimed at securing some public service, as in the case of the ten-year monopoly grant issued by the corporation of York to an individual for the making of fustians, on the grounds that this grant would supply employment for 50 poor people (Thirsk 1978: 66).

[20]Since corporations were explicitly excluded from the statute, a grant of monopoly to such an organization was a legal evasion of the law, and was frequently employed by the king later in the century (Gardiner 1965: 71). But as most such corporations had Parliamentary charters, such grants implicitly received parliamentary approval. Parliament could, and sometimes did, pull the charters of companies. Therefore, such companies had a powerful incentive to lobby for favors from both the king and Parliament. As Parliament became more involved with company charters and corporate affairs, company shareholders and officers increasingly sought membership in Parliament, where they would be well situated to defend their company's interests; Ruigh (1971: 56) offers several examples.

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purpose: the reallocation of regulatory authority from the monarch to Parliament. For example, the highly anti-competitive Statute of Apprentices was unaffected by the Statute of Monopolies; and the ability of Parliament to generate protection rents for favored interest groups by means of trade barriers remained the same (see Prestwich 1966: 243–44, for examples). In other words, the Statute of Monopolies *only* restricted the ability of the king to grant monopolies to favored individuals.

The Statute of Monopolies did institute one particular reform of great interest to barristers: it established that the common law courts were to determine exactly which monopolies were legally valid (Holdsworth 1945: 353). The common law had asserted such a claim in the earlier "Case of Monopolies," but the statute granted it the explicit sanction of Parliament.[21]

Coke was personally involved, directly and indirectly, in the operations of a number of important recipients of monopoly grants who benefited from the Statute of Monopolies, as he wrote it.[22] He was intimately involved in the resolution of disputes between chartered companies and alleged interlopers while a member of the Privy Council after 1613, and was frequently retained by that body in earlier years for advice. After joining the Privy Council, Coke became involved in numerous disputes involving the exclusive privileges granted to companies and corporations. For a time, he was an enthusiastic supporter of the Project of Alderman Cockayne to obtain the monopoly right to import linen. He supported both the salt and the coal monopolies. Coke's decisions in disputes over monopoly rights consistently tended to favor the monopolists; even the apparent exceptions inspire suspicion, such as his opposition to the privileges of the Merchant Adventurers during the time he supported Cockayne, one of their principal rivals.

Conclusion

Many classical liberals have written admiringly of Coke's purported role as a dedicated advocate of free enterprise against

[21]In 1601, even before *Darcy*, Elizabeth I issued a proclamation giving the common law courts the right to determine whether a monopoly was "injurious," and subsequently invalidate it. The Statute of Monopolies gave this proclamation statutory force (Holdsworth 1945: 360).

[22]He was the Chief Justice who approved the confirmation of the Charters of the East India and the Russia Companies; he settled the Charter of the Virginia Company; and was retained as counsel by the Draper's Company, the Cutler's Company, the Cook's Company, and the Stationer's Company. Since all ordinances of all crafts and guilds required the Chief Justice's signature, he signed off on the ordinances of the Merchant Tailor's, the Salters, and the Saddlers.

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governmental restriction. In fact, however, Coke only consistently opposed *royal* grants of monopoly privileges to specific individuals. (Ironically, many of these royal grants were dispensations from various statutory trade prohibitions, and hence tended to increase economic efficiency.) With equal consistency, he defended economic regulations enacted by Parliament, most of which generated entry barriers into markets which benefited specific interest groups, not specific individual persons. Common law jurists, barristers, and Coke personally all tended to benefit from the trend towards parliamentary regulation of the economy, because these legislated regulations tended to increase the demand for litigation in the common law courts. The shift towards more "modern" regulation by the legislature, from older grants of privileges to specific individuals, generated business for barristers.

Coke's selective attacks on certain kinds of monopoly grants occurred as part of his consistent efforts to secure more valuable and better enforced monopoly privileges for himself and his fellow barristers. The purported enemy of legal monopoly grants worked diligently to defend and expand the legal monopoly jurisdiction of the common law, of which he was a lifetime practitioner. He systematically fought against competition from other, non-common law courts, even in cases where those other courts provided superior service to litigants. The net impact of his activities in this connection seems to have been to make the market for adjudication in England significantly less competitive.

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Private Mail in Sweden

Jonas Frycklund

Introduction

On January 1, 1993 the postal monopoly was abolished in Sweden. At the same time it was announced that a new Postal Service Act was under way. The discussion leading up to this policy decision has a long and interesting history. The rationality of the postal monopoly has been challenged by several writers, primarily in the United States (e.g., Miller 1985; Adie 1985; Ferrara 1990) and in the United Kingdom (e.g., Senior 1989), drawing on empirical as well as theoretical evidence. This article shall focus on the lessons that can be learned from the Swedish example, with some emphasis on the historical development of the postal services in general and its competitive structure in particular. Private mail delivery existed during several historical periods in Sweden. Private companies were able to lower prices as well as introduce innovations into the mail market. In order to protect the Post Office and its monopoly gains, monopoly laws and decrees were introduced on several occasions, but time and again the postal monopoly was challenged, the latest being a private company, CityMail, which is operating in Stockholm since 1991.

The Post Office and Early Private Attempts

Before the establishment of a government-run Post Office in Sweden, the King's couriers had the right to free-ride on private coaches, a special form of discretionary taxation, so to speak. In 1636 the Post Office was organized as an independent entity. Since most mailing items at that time were of an official nature the State set up its own

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business. There also were periods when the operation of the Post Office was contracted out. This did not, however, change the state monopoly character of the business. The Post Office also rendered its service to private senders. This part of the business grew fast and made the postal business profitable. As early as 1660 attempts were made in starting private mail companies, only to be outlawed by decree (Generalpoststyrelsen 1888). In 1685 measures were taken to stop foreign competition. The Danish Post sent mail along the Swedish west coast on its way to Norway. En route the Danish Post received and delivered letters for Swedish customers. This practice was forbidden. At the beginning of the 18th century regular boat traffic was going between Stockholm and the university city of Uppsala. The boatmen started to transport letters and packets between these cities. This was outlawed in 1703. Illegal mail delivery was fined with a month's salary for the first attempt, two months' salary for the second attempt and dismissal and physical punishment for the third attempt. In 1716 measures were taken against private mail delivery between the west coast city of Gothenburg and Amsterdam in Holland. At the same time letters from harbors on the east coast to foreign countries were allowed to be transported by private ships on condition, though, that an ordinary postage fee was paid to the Post Office before the letter sailed, thereby charging the senders twice for the service.

Establishment of Local Mail Services

The Post Office was protected by a monopoly law. This law gave the Post Office the sole right to deliver letters between one domestic place and another, and between domestic places and foreign countries. Excluded from the monopoly statutes was mail delivery within a city or town. The reason for this exemption lies in the historical structure of the mail service. In the early days letters were only delivered between distant places, no local mail delivery existed. Since local mail service did not exist, and since nobody thought it was ever going to exist, it was not written into the monopoly law.

When a letter reached a town it was numbered and put up on a list at the post office. If you expected a letter, you had to go to the office and look for it. One can imagine people helping each other to look out for letters for family, neighbours, and friends. After a few days letters not picked up were transferred to a left-over list, and if possible they were delivered to the addressees. In 1669 two mailmen where employed to deliver left-over letters to addressees in Stockholm (Hasselrot 1985). In 1752 it was ordered that mail to

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Stockholm should be provided with information regarding street names and house numbers. Gradually mail delivery to private homes became the norm in Stockholm. In other cities, though, household mail delivery was not established until much later. For example Gothenburg, the second-largest city in Sweden, got its household mail delivery in the 1850s.

At this stage one can identify at least two remaining inconveniences for mail senders in Stockholm. First, the city still had only one post office, and the only way to send a letter was to go there. Second, these letters were only delivered to places out of town. If you wanted to send a letter within the city, you had to walk there yourself. Both these inconveniences were to be overcome with the help of a private initiative.

In 1838 a private mail company was established in Stockholm by Emanuel Mallén, a former regiment commissary. He, his wife, and temporary employees walked certain rounds in the city where they picked up letters and packets for a fee. They then delivered the mail to the post office, which distributed the letters to addressees in other cities. The Mallén business soon met competition from the grocers' stores, which began performing the same service (Mallén 1846). In a first attempt in 1842, and permanently from 1844 onwards, the Malléns also distributed letters to local addressees.

In 1848 the Post Office started its own local mail service. Letters were distributed to local addressees, but the letters still had to be handed in at the post office. In 1855 a system was introduced with stamps that could be bought in advance. Mailboxes were at the same time put up around the city where the senders could leave their letters. Mallén's service then became superfluous. As a gesture the government decided to grant him a yearly pension.

Stadsposten: A Private Mail Company in Stockholm

In 1882 the Post Office wanted to raise the local postage rate from 6 to 10 öre.[1] The Riksdag (the Swedish Parliament) settled on 6 öre, concerned as it was about the threat of private competition. In 1885 the local postage rate was lowered to 5 öre. This too was a measure of avoiding private competition.

On December 6, 1887 the threat nevertheless became real, when Anders Jeurling started his mail service called Aktiebolaget Stadsposten (Citymail Inc.). Jeurling was assistant editor-in-chief of a leading Swedish newspaper, and in the summer of 1887 he visited

[1] 100 öre = SEK 1.

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Copenhagen in Denmark (Stenberg 1987). There he was able to study the private local mail company Kjøbenhavns Bypost (Copenhagen's Citymail), which had been operating since 1879 (Christensen and Ringström 1974). Local mail companies were numerous at this time in Germany, Denmark, and Norway (Thunaeus 1936).

Back home he began planning for a private local mail company in Stockholm. Before he started his operation in 1888, Jeurling asked the government for permission which was granted. One could interpret this to be a discretionary measure on the part of the government and the conclusion could be drawn that no real free entry existed. A more plausible interpretation is to think of Jeurling's application as a mere precautionary measure. From the written law at that time as well as from the discussions in the Riksdag, one can infer that free entry was the case and that discretionary permission was not necessary.

Stadsposten set up mailboxes, distinguished by their color from the ones the Post Office was using. Stamps were distributed, and the price was set at 4 öre, 20 percent lower than the Post Office's. Stadsposten also accepted letters of greater weight than the Post Office. For some letters this meant a 60 percent lower price compared with what the Post Office charged.

The new private mail immediately became a success. Already in the first days of operation the number of deliveries reached almost 2,000 a day. The number of mailmen had to be increased and mailboxes needed to be emptied 5 times a day (*Dagens Nyheter*, 14 December 1887). During the first nine months of operation Stadsposten delivered 583,845 items of mail, i.e., an average of 2,123 per day (*Dagens Nyheter*, 7 September 1888). In the entire year of 1888 the number of delivered items was 824,492, i.e., an average of 2,259 per day (Stenberg 1987). The market share for Stadsposten in 1888 is estimated to have been 34 percent.[2]

A state monopoly can be expected to over-price and limit the supply of its services in order to maximize profits. In the case of so-called nonprofits this behavior is disguised because of rising costs. The profit motive of the Post Office, however, was quite openly

[2]In 1888 the Post Office delivered 48,225,000 items of mail in the whole of Sweden. The population of Stockholm was 234,990, and in the whole country 4,748,257. If we assume that mail delivery in Stockholm was proportional to mail delivery in general, a market share of 34 percent is derived. The assumption of proportional mail delivery is rather weak, as mail delivery could be expected to be higher in a capital. This would make the Stadsposten market share lower. On the other hand it has to be kept in mind that Stadsposten only acted on the intracity segment of the market, and on this segment the market share must have been higher.

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stated. In the Riksdag the loss of income to the State was put forward as a main argument against the private local mail companies (Stråle 1888, Törnebladh 1888). The over-pricing theory of monopoly is confirmed by the fact that Stadsposten was able to lower the price by 20 percent. The profit of the Post Office also sank temporarily during this period. In 1888 the profit was only SEK 36,116, compared with SEK 209,516 two years earlier, and SEK 475,703 two years later. This drop in profit can of course have other causes, but since the low 1888 figure stands out, the impact of the competition is very likely.

Another, and perhaps more serious, effect of state monopoly is the lack of incentives for innovation. The assumption that competition leads to a higher degree of innovation is supported by the evidence available for the 1887–89 period. During that time Stadsposten introduced a variety of innovations into the Swedish mail market. Right from the start subscriptions to newspapers and magazines were possible with Stadsposten acting as an intermediary, whereas the Post Office did not perform this service.

Stadsposten also introduced quantity discounts for items sent as printed matter, including advertising. Later on Stadsposten started printing letter-cards with the buying firm's logotype printed on the envelope. The advertising value of this was recognized, and letter-cards were printed, covered with advertisements, and sold to the public at a discount for 3 öre. The customer then not only could lower his postage rate but also got the envelope free. In comparison with the Post Office's postage rate this meant a 40 percent discount.

In cooperation with the State Railways Stadsposten began delivering parcels from various places in the city to the railway station. The parcels were then distributed by the State Railways to other railway stations in Sweden and Norway. A new service for associations was introduced by Stadsposten, as the private company started to collect membership fees. The membership fees could be paid directly at the door to the mailman.

Monopoly Decree of 1888

The private local mail delivery became a political issue in the spring of 1888. In the second chamber of the Riksdag Lasse Jönsson proposed that the postal monopoly should be extended to include the local mail service also (Jönsson 1888). In the first chamber similar proposals were put forward by Wilhelm Stråle (Stråle 1888) and Ragnar Törnebladh (Törnebladh 1888). The arguments put forward against private competition were: that it was unnecessary, that it

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made it difficult for the public who had to use different types of stamps and mailboxes, that the public was quite satisfied with the existing Post Office service, and that the State would lose its present income from the Post Office.

The matter was drafted in committees in the respective chambers. The committee reports subscribed to the monopoly proposals, and even extended the monopoly argument by claiming that Stadsposten was only serving the more profitable parts of Stockholm and let the Post Office handle the other not-so-profitable parts. The two chambers united in proposing that the government issue a decree whereby the local delivery of closed letters as well as postal cards would be included in the postal monopoly. This was done, and Stadsposten was given a respite time before it had to go out of business on October 1, 1889.

If examined more closely the arguments for a monopoly turn out to be rather weak. First, the claim that a private mail delivery was unnecessary, and the public was happy with the services the Post Office rendered, should of course best be tested on the market and not judged out of hand. Second, the supposed troubles for the public obviously were not of such a degree as to warrant a monopoly. Certainly, letters with the wrong stamp were put in the mailboxes of both the Post Office and Stadsposten. If a Post Office letter was put in a Stadsposten box it was transferred to a Post Office box. This procedure only caused a minor delay. On the other hand if a Stadsposten letter was put into a State mailbox the addressee had to pay a stamp fee to get the letter out. The major cause of trouble for the public was consequently the stubborn behavior of the Post Office, and this could hardly be a valid argument against competition.

In any case, in the absense of consent about how to evaluate these difficulties, here again the market should be the judge. The fiscal argument can only be valid if one chooses a politicians' view, and sympathizes with their desire to maximize the budget without having to raise taxes openly. If one chooses the view of the public, the answer leads in a different direction. A hidden tax on mail delivery is as bad as any other form of taxes, and if for some reason this tax form is chosen, it could be implemented under private competition as a mail sales tax. Finally, the accusation that Stadsposten only served the most profitable parts of Stockholm does not seem to be accurate. Certainly, the operating field of Stadsposten was limited in its original statutes. But these self-imposed limitations soon became superfluous when the business grew. As a result Stadsposten in practice served the entire city of Stockholm (Gumaelius 1888). Still, even if Stadsposten had 'taken the best plums', this would not have

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been a valid pro monopoly argument. The only thing this would have proven was that, under the old regime, the profitable customers had to subsidize the others.

Private Local Mail 1925 to 1947

The monopoly decree of 1888 did not include open letters, newspapers, printed matter and parcels. By 1925 the market for delivering these items had grown to the extent that private competition once more became possible. Private mail companies started in the larger cities, some of them not lasting for long. Probably the most successful business was the private mail company in Helsingborg, which operated between 1926 and 1947 (Hoverby 1985).

The private mail company in Helsingborg from the start charged 4 öre for a local letter, compared to the 10 öre charged by the Post Office. In 1944 the price was raised to 6 öre as a reaction to the Post Office raising its price to 15 öre. The Helsingborg business had mailboxes around town and worked on the same basis as the Post Office. The major drawback for the customers was that letters had to be open. The market share for private mail in Helsingborg in 1945 is estimated to have been 5 percent.[3]

In 1944 the local postage rate of the Post Office was raised from 10 to 15 öre. This immediately made the private local mail delivery more profitable. Private mail businesses boomed and about 50 firms were established in different towns during 1945, and about 25 of these lasted till 1947. The newly established companies usually charged 8–10 öre for their delivery of open letters.

The private mail companies formed an association to take care of common interests. Suggestions and attempts were also made toward establishing intercity transfer of letters between the private mail companies. At the same time the Post Office started to combat the private mail companies. If a letter with a private stamp was put in a Post Office mailbox, the addressee had to pay a stamp fee to get it out. The Post Office also systematically tried to send closed letters with the private mail businesses in order to gather evidence for future trials.

The boom of private local mail delivery was not foreseen by the government. In order to put an end to the threat to the Post Office

[3]In 1945 the private mail company in Helsingborg delivered 445,460 items of mail. The Post Office delivered 860,200,000 items in the whole of Sweden. If proportional mail delivery in Helsingborg and Sweden is assumed, a market share of 5 percent is derived. Since the private mail company only acted on the intracity segment of the market, the true market share on this segment must have been higher.

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a monopoly decree was passed in 1947 whereby open letters were included in the postal monopoly also. The statutes were ratified by a unanimous Riksdag and the private mail companies had to close down on July 1, 1947.

CityMail and the Revival of Private Mail in Sweden

Since May 1991 a private mail company is operating in Sweden called CityMail. At present only the city of Stockholm is served, but the plan is to expand to other urban areas. CityMail now reaches 15 percent of the Swedish households.

CityMail delivers mail from companies, associations and authorities to various addressees. This mail is already sorted by computers when it is picked up by CityMail, which lowers the costs for the mail delivery and makes it possible for CityMail to give generous quantity discounts to their customers.

From the start CityMail claimed that their service was not included in the postal monopoly. In November 1991 this interpretation was supported by the district attorney. In October 1992 the situation became unclear when the chief district attorney changed the former decision and decided to investigate a supposed violation of the postal monopoly decree.

The Minister of Transport and Communications Mats Odell initiated a process that led to the abolishment of the postal monopoly on January 1, 1993. The Director-general of the Post Office supported the abolishment. As a consequence the investigation concerning violation of the postal monopoly was dropped.

It has been announced that the abolishment of the postal monopoly shall be followed by the introduction of a Postal Services Act. This act will state that there shall be a nationwide postal service enabling letters and parcels to reach all addressees at a uniform and reasonable price. The responsibility for ensuring the availability of this service rests with the State. In practice the basic postal service—at least for the immediate future—is likely to be managed by the State-owned postal corporation. The new act will also include rules on the handling of undelivered letters and the protection of confidentiality.

The Post Office has started to compete with CityMail by giving discounts to large customers in the Stockholm area. Because of its size the Post Office, at least in the short run, has an advantage of being able to reallocate vast resources to areas where it meets competition. This was especially the case before the postal monopoly was finally abolished. In October 1992, when the legal status of City-

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Mail's business was uncertain, the company got into financial trouble. New capital has since been invested in the operation and according to CityMail's president the financial situation is now satisfactory.

A company similar to CityMail, though smaller, was started in January 1992 in the rural area of Skaraborg. This company delivered mail from companies and authorities to households in a number of small municipalities. The towns as well as the surrounding countryside were fully covered. This business was closed down in the autumn of 1992.

Conclusion

The Swedish experience tells us that private mail services are likely to emerge in the market whenever there is a possibility due to loopholes in postal monopoly legislation. It also gives evidence that private competition tends to lower costs and stimulate innovation. When occurring, private mail services have been met with prohibition by the government. An exemption to this were periods between 1838–55 and 1925–44, when the private mail services were small and regarded as non-threatening to the Post Office.

The latest period of private competition in the Swedish mail market began in 1991. Instead of attempting prohibition the Riksdag has made postal competition legal. This could be interpreted as CityMail not being regarded as a major threat to the Post Office. On the other hand it could also be a symptom of a changed political and public opinion regarding state monopolies.

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Indigenous African Institutions and Economic Development

Emily Chamlee

Introduction

In the attempt to establish institutions which foster economic development in the third world, economists often look to the West as a model. This indeed has been the case in Ghana, West Africa. In Ghana's urban centers, the large buildings which house Barclay's Bank, Standard Charter Bank, and Ghana Commercial Bank loom over the traditional market stalls and street traders. This sight might be heartening to those who recognize third world entrepreneurs' limited access to capital as the primary constraint in advancing economic development. Indeed, these institutions play an important role in financing large scale industry and high volume import and export exchange. But this is only a small proportion of market activity in Ghana. The majority of business people never enter the doors of such institutions.

The most striking feature of West African markets is the overwhelming proportion of female traders. While a few items will traditionally be sold by men, most of the trading activity is conducted by women. For example, the United Nations Development Fund estimates that 80 percent of all food production, processing, and marketing in West Africa is carried out by women. While limited access to capital is of general concern to development theorists, the limits facing female entrepreneurs are considered to be particularly severe (Simms 1981). The presence of formal Western-style credit institutions has done little to alter the situation.

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The observations presented here are three-fold. First, the reasons why Western-type credit institutions have not reached the average West African entrepreneur will be explored. It will be argued that formal banking procedures have evolved to fit a Western cultural context and cannot be expected to fill the same role in the West African context. Second, indigenous credit and mutual assistance institutions which could potentially fulfill this role will be identified. Such institutions will be shown to reflect the cultural context in which they emerged, and how they in turn can accommodate specific credit needs. Third, the obstacles facing such indigenous institutions will be identified, with the purpose of suggesting shifts in policy. The analysis presented here is primarily based on findings from interviews of 49 market women conducted in the central markets of Accra and Kumasi, two prominent trading centers in Ghana, and the smaller market Madina, which is outside of Accra.[1]

Western Credit Institutions and the Local Entrepreneur

Recognizing the inability of Western credit institutions to reach the small entrepreneur is not to suggest a case of market failure or that such institutions were not as important a part of Western economic development as we had thought. Rather, these institutions are quite successful when operating within a specific cultural context. While it is easy to recognize the impact a certain cultural context has in general, the fact that formal Western institutions also emerge out of and reflect a particular culture is often lost, when analyzing third world institutions.

Western or Western-type financial institutions have emerged in a setting where the entrepreneurs are for the most part educated, literate, and male (so entrepreneurs are not at risk of being locked out of the process simply for the reason of gender). Entrepreneurs demonstrate their credit worthiness with a documented credit history, and the cultural setting she lives in supports this method of accountability with rules of record keeping and documentation. Thus, it is not surprising that institutions which have emerged in this context are not successful in providing financial services to the bulk of the population in the West African context, given that small entrepreneurs are for the most part illiterate women, the least educated members of society. It is a matter both of the small business person not

[1]In Accra, interviews consisted of 15 street vendors, 12 stall traders, and 9 lock-up shop traders. In Kumasi, interviews consisted of 4 street vendors, 3 stall traders, and 3 lock-up shop traders. In Madina, 3 stall traders were interviewed.

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accepting the practices of the formal banking institutions as well as the formal banking institutions not having much interest in reaching out to this section of the market. In short, it is simply too costly for the formal institutions to offer lending services to the small entrepreneur.

Market women are not likely to be familiar with complicated bank procedures, particularly the written forms. Many women, even in the urban markets speak only their local language and not the official language, English. For the banks' part, the only gauge of credit worthiness of potential borrowers is to require a long term savings account. The majority of market women could scarcely dream of acquiring the sum needed for an initial deposit (Lycette 1985). This is not to say that a credit history does not exist, rather that the formal institutions have no way of acquiring this information, as it is embedded within the kinship and "sororital" alliances. Even if they are able to establish a savings account, any loan amount for which they would be eligible would not be worth the bank's time to process and administer. Having evolved in a Western context, formal banking institutions have developed a corporate culture and a system of rules into which Ghanaian market women simply do not fit.

Indigenous Solutions to Acquiring Credit

Indigenous financial arrangements provide an alternative to the formal banking system. The potential of these alternative arrangements is not widely considered to be promising, however, given that the amount of credit most often extended is no more than a few dollars (Robertson 1984). Yet, there are still reasons not to dismiss the indigenous arrangements out of hand. First, we must recognize that the bulk of investment activity is financed through indigenous arrangements and not the formal banking institutions. Thus, even if the indigenous sector faces strict constraints, they are nevertheless serving a valued function in the market that is not met elsewhere. Secondly, it is not necessarily the case that larger loans are needed. The relative success of development programs such as the micro-loans project in Bangladesh and other areas indicate that small loans of just a few dollars can make a substantial difference. Thirdly, to the extent that the indigenous arrangements are stunted, it is often the result of state regulation and restrictions on trade. Thus, an investigation into the operations of indigenous financial solutions will help us identify which regulatory practices cause the most disruption to their ability to function.

The size, scope, and function of indigenous credit and mutual assistance societies will first be detailed, indicating the essential

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features for their proper functioning. Then, the major obstacles attenuating the progress such societies might deliver will be discussed. Lastly, the relevant institutional and policy shifts which ought to be considered if the indigenous solutions are to provide the maximum possible benefits will be addressed.

Women's associations vary in size, scope and function. Such societies are traditionally based in kinship and tribal structures. It might be said that migration both into the city by those from the rural areas, and out of the city to the suburban areas has caused irreparable damage to the kinship and tribal systems such that they can no longer perform the advisory and credit functions to the degree that they once did. But to the extent that these structures provide less support for those in the urban environment, other culturally based support systems are evolving to fill the void.

Christian churches, particularly in Accra, provide another layer of community involvement. Almost all the Christian church organizations provide some form of mutual aid on a regular basis. Many also play an advisory role for traders looking to expand their business.[2] Some even provide an opportunity to acquire credit through church programs specifically designed to start people in business. Thus, to the extent that the ability for kinship and tribal structures to provide these services is faltering in the urban areas, the religious institutions are stepping in with similar services of their own. As Western religious institutions replace traditional forms, they have had to adapt and expand their role in the new context. Specifically, they have had to take on at least some of the functions previously performed by traditional structures.

The second important support system that is filling the void left by the decline of tribal and kinship structures in the urban areas is the formation of female societies which cut across tribal and kinship lines. These can range from small clusters of 3 to 5 women who trade near one another on the street to the elaborate trade organizations of several hundred women in the established markets. Inclusion in the clusters or organizations is not solely determined by tribal affiliation or kinship ties, (though these are still important when they exist). Successful face to face interaction which is repeated daily engenders the trust necessary for the formation of close bonds. Physical proximity allows traders in a specific area to observe one another's

[2]Of the 25 women who were asked about their religious affiliation, 4 were Muslim, 2 were agnostic, and the rest were Christian. Among the Christians, 14 different churches were represented. Of those, only the Assemblies of God, Central Gospel Church, and Deeper Life Ministries did not offer mutual assistance for funerals, births and marriages. All but the Anglican Church and the Central Gospel Church offered regular opportunities to receive business advice.

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behavior, as well as establish a reputation for themselves. The question arises: can we not then speak of these clusters or organizations of women as a *culturally* based phenomenon? In other words, does gender constitute a cultural structure as, for instance, tribal affiliation does?

The answer is "yes" when we recognize that in the West African context, gender itself provides the basis for cultural specificity. West African women indeed have a culture distinct from that of West African men. The same is the case for children in the West. Deborah Tannen's (1990) work demonstrates that same-sex play groups during childhood lead boys and girls to develop distinct cultures from one another, and this explains many of the systematic differences between the ways in which adult men and women relate to one another. Tannen's argument is that as children establish same sex peer groups, boys and girls develop separate language patterns. Besides communication, male peer groups use language to establish status, or hierarchical relationships. Female peer groups, on the other hand, use language to establish connection, or more lateral relationships. As these different language patterns develop, so do distinct cultures. As Western children enter into adulthood, the male-female relationship tends to replace the same sex peer group as the primary relationship. Yet each retains the behavioral and linguistic patterns learned as children. Thus, communication between men and women is essentially cross cultural communication.

Given that this is the case in the West, consider the importance a female specific culture is likely to play in the traditional West African context. The conjugal unit, while not incidental, rarely replaces gender specific groupings as the primary relationship. The mother-daughter relationship, for instance, plays a primary role throughout a woman's life, even as the daughter marries. The strict division of labor across gender perpetuates the importance of same sex peer groups into adulthood as women work side by side with one another. The traditional role female cooperation plays in production, child rearing and the enforcement of social norms (Sudarkasa 1981, Wipper 1984) also perpetuates the influence of a gender specific culture into adulthood. The most dramatic instance lies in the traditional compound system which separates living quarters for men and women (Robertson 1984).

Most of the market women, particularly those at the more marginal levels of operation exhibit a strong sense of camaraderie with the women who trade in their immediate area. The traders form themselves into close-knit groupings, or clusters, sometimes as small as three to five women. These connections serve a vital economic function of mutual support. Even direct competitors will sell for one

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another in the case of sickness. Most traders are socially, as well as financially linked with other traders.

Anthony Kronman (1985) describes this method of reciprocal behavior as "union," whereby individuals seek to "reduce divergence (of interests) by promoting a spirit of identification or fellow-feeling between the parties. . ." (Kronman 1985: 21). As opposed to other arrangements designed to combat opportunism, "union" does not assume opposition of interests. Rather "[union] seeks to eliminate the condition of separateness that makes the opposition of interests possible in the first place" (Kronman 1985: 22). Thus, casual chat, gossip, and in-depth discussions which involve traders in one another's lives serve more than just a social function, but are also an important prerequisite for securing mutually supportive financial relationships.

Robert Axelrod (1981) describes how a high probability of repeated interaction generates cooperation under conditions where (1) there is no sanction for breaking the rules of cooperation, (2) there is no way to gauge the behavior of other players outside of the game, and (3) there is no way to change the other players' utility function. While Axelrod's analysis is internally consistent, it is not as applicable to the specific case of West African market women as Kronman's "union." First, West African market women do indeed have sanctions for breaking the rules of a credit society. Indigenous arbitration methods (discussed below) and the threat of ostracization are time honored methods of minimizing such opportunistic behavior when it does occur.

Second, the ability of traders to gauge one another's behavior in their day to day trading activities is a vitally important source of information. Simply bumping into another trader day after day is not enough to ensure a successful cooperative link. Trust, of which repeated interaction is only a part, must also be established. Trust involves careful assessment of another's character, not simply calculating the probability of seeing the same person again. A trader may faithfully return to the market day after day, but if she is frequently rude to her customers, is a spendthrift, or is drunk on a regular basis, other traders are not likely to see her as a good risk. The repeated interaction enables this assessment, but by no means constitutes trust in and of itself. Third, Axelrod's condition that the players cannot interact outside of the game, or in other words, cannot influence the feelings one has for the other, is clearly not applicable in this case. The bonds of friendship are paramount in establishing the financial support networks.[3]

[3]Klein and Leffler's (1981) discussion concerning the role advertising (or investment

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Women at the upper end of the scale who have been financed by their husbands, however, often do not show as much interest in joining together with other women. One relatively prosperous batik trader refused to take part in any of the trade or credit associations. In fact, she reported that she did not gossip or go out of her way to be sociable with the neighboring traders. She resented the thought that illiterate women would try to tell her how to run a business. She thought that the associations were more for the illiterate traders, not for someone as well educated as she. This woman's business was financed, however, by her husband who held a prominent civil service position. Further, the fact that her husband was able to buy a large house gave her the opportunity to produce the batik herself as the process requires a large protected space. This gives further indication that the female camaraderie plays more than just a social role, but serves a financial function of which relatively wealthy women need less.[4]

Hawkers (Street Vendors)

The smallest forms of indigenous credit and mutual assistance occur among clusters of women who sell in the same area. Such clusters will gather to engage in group "susu." Members of a group susu association make either daily or weekly contributions to a common pot. The pot is then distributed to members in turn, usually on a monthly basis.[5] These arrangements can be on-going or for specific purposes. Engaging in group susu has the advantage over saving with a "susu man" as he charges a commission of one day's savings per month. Further, depending on the rules the group wishes to follow, the women who receive the pot first have a source of free credit.

While the susu arrangement offers a financial resource, credit can also come in the form of goods. Women who have lost their capital will often rely on friends to advance them produce or other goods

in one's reputation) plays in the success of contractual performance is also illuminating here. According to Klein and Leffler, such investment is like posting a bond, signaling a credible commitment to fulfilling the contract. Kronman's "union" still seems more applicable, however, in the case of West African market women, given the emphasis placed on shared interests in the "sororital" order.

[4]Fifteen out of the 18 stall traders interviewed (about 83 percent) belonged to trading associations, whereas only 5 out of 12 (about 42 percent) of the more prosperous lock-up shop operators belonged.

[5]Hawkers who have no fixed trading position tend to save anywhere from C200-C500 ($.47- $1.18) per week. Thus, if there are four members in the group, each will receive C800-C2000 ($1.88-$4.71) once a month. See Little (1965) and Little (1973) for details of rotating credit associations in other areas.

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for which they will pay at the end of the day or the week. One woman who lost her capital through fines levied by the city council helps her friend sell rice in return for a small sum at the end of the day. This amounts to a transfer, as there is no benefit to the rice seller for "hiring" her friend, yet the ethic of mutual support is reinforced so that the rice seller could rely upon similar support if such a situation were to befall her. Besides financial support, this arrangement also affords the opportunity for the woman who has lost her capital to maintain her position in the peer group, so that when she is able to secure her own goods for sale, she will be able to ease back into the market culture.

Generally, among street vendors, there is little opportunity to belong to an on-going mutual assistance society,[6] as they do not have the financial capital necessary to make regular contributions, but the "hat will be passed" as needed to aid friends who have given birth, are getting married, or who must provide funeral arrangements for a family member.

Since trading on the street is officially illegal, a system of *de facto* property rights has emerged on the sidewalk. As the city council guards make their way down the street, the hawkers pass an audible signal to alert each other to the guards' presence. As if choreographed by Busby Berkeley himself, the traders hoist large trays of fruit, vegetables, fish, utensils, and other goods atop their heads. Women who sell goods too heavy to place on their heads need to secure a position close to the entrance of the established market. Once the signal is heard, she can quickly move her goods inside the market and lose the city guards in the maze of the market, (a maze far more familiar to women than the male guards). Many women "inherit" these positions in the market from their mother, an aunt, or a sister. When a position is well established, any woman who attempted to encroach upon this space would be harassed out of the spot by the surrounding women with a barrage of insults. This de facto property rights system enables larger groupings, as women can count on their peers returning to the same spot in the market.

Let me point out, however, that de facto property rights are not as efficient as full rights of ownership. Following Armen Alchian and Harold Demsetz's (1973) identification of the essential elements of private ownership, de facto property rights fall short of the mark.

[6]Some women will still have such support within their home village. But access to such support would most likely require returning to the village, as much of the assistance is given in-kind rather than in cash. Women are reluctant to take advantage of this source of support if it means they must give up the independence and financial prospects the urban setting offers.

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Specifically, while de facto private property rights provide some level of stability and excludeability, the element of transferability is significantly stunted. Stability is maintained as long as a trader consistently returns to the same location. Further, neighbors will often exclude would-be interlopers from taking over a selling position in the case of the limited absence of another trader. But the efficient allocation of the resource depends on the ability of a trader to smoothly transfer it to another. While selling positions can be "handed down" from mother to daughter[7], for example, generally, traders cannot sell the space to the highest bidder. Among her neighbors, a trader's legitimate claim to a selling position only holds as long as she maintains that position. Thus, while the de facto property rights system works remarkably well, it cannot guarantee the efficient allocation of resources.

Many women are fortunate enough to have established a contact with a store-front shop owner, with the agreement that the owner will allow the street vendor to hide in the shop when the city guards pass by. While there is an opportunity for side payments here, most women who have such a position acquired the favor through personal contacts. The lack of payment, however, should not be seen as a sign that such permission does not represent a valuable resource to the street vendors, as it enables them to engage in more substantial credit relationships, again, because of the decreased flight risk. Further, the stable position enhances profits as the trader is able to establish a regular clientele.

Among the hawkers who secure stable trading positions at the entrance of a store, the group susu societies grow from about 4 to about 12 members. The monthly pot for a four member group where each contributes C200 per week is C3,200 ($7.53) while the monthly pot of a 12 member group with the same contribution is C9,600 ($22.59). The annual return per member does not change as the size of the group grows, but the larger monthly pot will be more helpful in acquiring costly pieces of equipment or a move into selling a more lucrative product. Further, because of the combined effect of the reduced flight risk and the benefits of building a regular clientele, the contributions tend to increase among traders who have established trading positions. Thus, we see that a well established trading posi-

[7]This process happens over time. The mother, for instance, will begin by bringing her daughter to the market. The daughter will circulate goods on the street, returning to her mother's position for more supplies when needed. Eventually, the daughter may sit with her mother, establishing a rapport with the other traders. By the time the mother quits the market, the daughter has already established her legitimate claim to her mother's selling space.

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tion translates into substantial financial gain when we consider the difference between a C9,600 ($22.59) *per capita* annual return for a susu association with contributions of C200 per week, and a C28,800 ($67.76) per capita annual return where the contributions increase to C600 per week. Below I will discuss some of the particular obstacles hawkers face in acquiring even more stable trading positions.

Market Stalls

Credit and savings associations and mutual assistance societies take on a different character once inside the established market stalls. Though the market stalls officially belong to the city council, the de facto property right in the market stall allows for more complex credit and mutual assistance associations to develop. The number of participants in even the informal arrangements often increase to 20 or 30. The amount of contributions also increases, partly because these women have more money to save, but also because a woman is very unlikely to abandon a stall to avoid contributing to a group susu organization. Trust still plays an extremely important role here, as newcomers are not quickly included in such arrangements. A trader's behavior is carefully observed and her character closely assessed before she is given a chance to prove her trustworthiness. If she drinks too much or comes to the market late, her neighboring traders are likely to conclude that she will not last long in the market, and thus she is a risk to the rest of them if she were to be included in any financial arrangements.

Within the established markets, a separate trade association exists for almost every type of good sold. The functions performed generally do not include credit, though informal side arrangements are facilitated by the frequent contact made between members in the associations. They also serve a quasi-political function as grievances to the city council will be made through these organizations. They serve a regulatory function by reinforcing behavioral norms. Consistently rude or dishonest behavior can be met with termination from the association. In turn, the association provides financial security in the form of mutual assistance benefits for funerals, marriages and births. Health benefits are also often provided out of the fund of regular contributions. Membership within the association is not required, though it is particularly advantageous for those far from their home villages and separated from the family support system.

Though sometimes there are attempts made by a particular association to restrict the number of sellers and enforce cartel prices, these efforts have been largely unsuccessful. The general feeling in the market is that such anti-competitive behavior is not a legitimate role

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of the associations.[8] The hair stylists' association recently tried to prohibit any non-member from practicing inside Makola market in central Accra. The issue was brought before the market queen who ruled in favor of the hairstylists who wished not to be a part of the association.

The other major functions these associations fill are giving business advice to those having financial difficulty and providing arbitration services. Disputes between members of the same association can usually be handled internally. If the dispute involves traders of two different associations, the case can then be brought to the market queen.[9] Each major market chooses a market queen. Traditionally, the market queen is chosen by consensus. Through sustained face-to-face interaction in the market, the most trustworthy and experienced traders were easily identifiable. In the larger urban markets, there is the possibility for more than one choice, thus an election process has been implemented. The results are essentially the same, however. As long as a leader maintains the respect of the traders, a market queen is likely to serve many terms.[10]

Lock-up Shops

The next level of market activity is the lock-up shops, concrete structures in which traders can leave their goods overnight. These

[8]Of the 30 women interviewed inside the established markets, 20 were members of a trading association. The traders who did belong were asked if their association regulated the prices they charged. Virtually all said that their association (16 represented in all) did not. Most traders indicated that they would quit the association if it attempted to put such controls on their business.

[9]Officially, the case could ultimately be appealed to the city council. According to Francis Eshun, the public relations officer of the Accra city council, these disputes are often simply "petty female squabbles" and the council is reluctant to become involved. If the city council must pass down a judgement, they generally support the decision of the market leaders so as to discourage future requests for intervention by the council. Though it is a misconception that these disputes and their resolution have no real economic consequences, it is on the other hand a fortuitous one. By endorsing a policy of staying out of "petty female squabbles," the integrity of the system of conflict resolution is not undermined by bureaucratic tinkering.

[10]There is also a market queen who presides over the collection of all the smaller markets in the urban areas. In Accra, this position has been held by a woman named Manan Lokko since the early 1950's. Since she is too old to come to the market every day, her role is primarily symbolic. However, she is an extremely important symbol, as is demonstrated by her ability to mobilize opposition to city policies. When the city council announced they were moving the market women away from the Rex Cinema, a central location in Accra, in order to start construction of new office space, the market queen was able to summon thousands of women to the steps of the city council. The administrators inside the city council reported many staff problems during this time, because all the workers in the office had some tie, either a sister, a mother, an aunt, or wife in the market, who was pressuring them to use their influence in the city council to stop the policy from being implemented.

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women have all the options open to them for acquiring credit that the stall traders do, but will frequently have further opportunities for acquiring credit. Some cloth manufacturers, for example, put high volume traders in contact with one another, the hope being that by pooling their resources they will be able to purchase even larger quantities. This is also a way for the manufacturer to share the risk, and thereby grant more cloth on credit. If a member of the cluster is short on her share of a payment, the other members will cover it knowing that they may need the favor returned at some future time. These clusters often form the basis for expanded business ventures, and are a trusted source of business advice.

The capital needed by a trader to secure a lock-up shop is considerable. To be assigned use of the space, she must pay the city council C26,000 ($61.18). She is also responsible for the construction of the structure itself, (a structure which still officially belongs to the city council even though she pays for its construction). A simple 8' x 12' concrete structure costs about C550,000 ($1,294). In addition to this, she pays an annual rent to the city council of C20,000 ($47).[11] If she has this kind of working capital, she is far more likely to be able to secure a loan through one of the official banking institutions. Once she is operating at this level, it is generally not a problem acquiring credit in this way. The problem is in reaching that level. The minimum savings and deposit requirements for starting and maintaining a savings account (the only way to prove one's credit worthiness to the official banking establishment) is a distant possibility for most traders in the market.[12]

Impediments to Indigenous Institutions Fostering Economic Development

What is stopping the evolved indigenous institutions from fostering more economic development? In her study of Ivorian market

[11]Note that these figures do not include taxes, the magnitudes of which will depend on the particular good sold and the volume of trade. The operating taxes range from C40 per day (about $.10) for small scale street vendors to C100,000 per year ($235) for larger scale cloth sellers in lock-up shops.

[12]Both Standard Charter and Ghana Commercial Bank require an initial deposit of C10,000 ($23.53) to open a saving account. They will not consider a loan for less than C100,000 ($235). For a first time loan, they require cash collateral of half the amount of the loan, plus property or a guarantor. In addition, the borrower must insure the shop and goods such that the loan will be paid off in the event of extensive accidental damage or theft. Barclay's Bank requires a minimum initial deposit of C50,000 ($118) to open a savings account and will not consider lending less than C1,000,000 ($2,353). Again, the first time borrower must provide cash collateral of half the amount of the loan, plus property or a guarantor. Barclay's Bank requires the borrower to purchase life insurance in order to secure the loan. A policy for a healthy 30 year old will cost

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women, Barbara Lewis (1976) cites the erosion of tight kinship ties and particularly the individualist character of the market as the reasons for the decline of the rotating credit associations and indigenous mutual assistance societies. It seems unlikely, however, that after centuries of competitive markets, individualism is the cause of these relatively recent problems. She does not seriously consider the role government policies have played in stunting the effectiveness of indigenous arrangements of credit and mutual assistance, a line of inquiry essential to understanding the Ghanaian context. More than any other influence, state and municipal control of resources and market mechanisms has inhibited indigenous institutions from providing credit and mutual assistance and thus has retarded the development of the local economy.

Criminalizing Market Activity

In 1979, Flight Lieutenant J.J. Rawlings staged a military coup to oust the corrupt head of state Acheampong. Rawlings promoted his regime with an anti-corruption campaign, ordering the incarceration (and sometimes death) of bureaucratic elites who hoarded consumer goods and dealt in political favors. The rhetoric of the military regime struck a popular chord with the average citizen who had been locked out of the system of privilege yet was spending more and more for basic requirements. Rather than seen as a reflection of perverse incentives introduced by the marketing board structure, the relatively high prices of corn, cassava, yam, and other basic items were unfortunately seen as part of the general graft and corruption.

In retaliation for selling above the state-controlled prices, the major markets of Accra were destroyed. In central Accra, government soldiers flattened Makola Market Number One with dynamite. Many women were beaten and publicly flogged, their heads shaven, and often imprisoned. This contributed considerably to the general decay of indigenous markets in the early 1980s, where even produce which grows abundantly in the Ghanaian climate could not be found for sale in the urban areas.[13]

For a short period, government control was turned over to civilian rule, but conditions did not improve, as the President Dr. Hilla Limann, retained the policy of stringent price controls. On December 31, 1981 Rawlings staged another coup, this time stepping up his

around C150,000 ($353). Barclay's Bank also requires potential borrowers to carry out the bulk of their transactions in the form of checks. Small entrepreneurs deal only in cash both when purchasing supplies as well as in accepting payments.

[13]Many women abandoned the urban areas to return to their rural villages, as subsistence farming was more lucrative than urban trade under such circumstances.

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anti-capitalist rhetoric. Drawing on a mixture of dependency theory, anti-Westernism, and Nkrumah's neo-colonialism, Rawlings favored at least a partial withdrawal from the global economic system (Haynes 1989: 109). Never did Rawlings blame his own interventionist policies for the continued economic decline. Only in 1983, when he was in considerable danger of losing political control, did he grudgingly release the price controls as a condition of an IMF Economic Recovery Program (ERP). Since the controls were lifted, the local economy has slowly improved, but the experience has left deep scars.

Currently, the illegality of trading on the street is still a major barrier to the most marginal of all traders from accumulating the capital necessary to secure a market stall, cooking equipment, or any other means of expanding a business. While officially, trading on the street is illegal, unofficially it is tolerated. This does not mean, however, that the city council simply turns a blind eye. Rather, the ambiguous status of hawkers places them in the precarious position of being hit from both sides.[14]

The most cautious strategy a street vendor can take is to always keep moving, as the general rule is that city guards will not fine a trader as long as she does not loiter in one spot. This however means that she cannot establish a predictable trading position and therefore cannot build a regular clientele. On the other hand, hawkers who establish a consistent trading position run a greater risk of being fined or at least pressured for a bribe. Evidently, the guards are keen enough to price discriminate. The bribes can be a token C200 (about $.50) or bag of rice or tomatoes every couple of weeks, or can be a more substantial amount of C1,000 to C2,000 ($2.35 to $4.71) a week if the city council guard chooses to target a trader he knows is running a profitable enterprise.

While these kinds of costs are imposed upon hawkers because of their officially illegal status, the fact that it is unofficially tolerated means that the city expects a daily tax from each trader. Thus, the ambiguous status of the street vendor is as much a curse as it is a

[14]The ambiguous status of these women is demonstrated by the attitudes of the city council guards. At midday, guards can be seen carrying on polite conversation with and purchasing *kenkey* or small meat pies from the same women to whom they are meant to be issuing a citation. Yet, once or twice a week, guards can also be seen making their way up a street violently smashing the stools and tables upon which women will sit or set their wares. During these demonstrations, no fines are issued, no bribes are solicited. There is no purpose here other than to send a clear message that the street traders are in fact criminals.

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blessing. The daily tax[15] paid to the city council guards, the fines levied when a trader is caught setting her wares down on the sidewalk,[16] the loss taken when supplies are confiscated by the city council, and the regular tributes paid to the city council guards to avoid citation, when added together represent a substantial burden upon street vendors.

In Accra, about 1,500 traders per month have their goods confiscated and must pay at least C5,000 to the city. A single C5,000 citation can mean the difference between being able to feed a family and economic ruin. Besides the taxes and fines, there are implicit costs as well. Even if the fine is paid and the goods are returned, perishable supplies are often spoiled as it may take several days to borrow the money from friends and family. Further, once confiscated, the goods are in considerable danger of disappearing into the pockets of city council employees. In turn, the trader is likely to lose a valuable source of credit if because of the financial burden of the fines and the loss of her goods she is unable to or late in paying her suppliers.

Monthly incomes of street vendors have a wide variance, anywhere from C7,000 ($16) to C28,000 ($66). Thus, the daily tax and two small tributes of C250 translates into 23 percent of a C7,000 monthly income. Nearly 95 percent of a C7,000 monthly income is lost to the city council if the trader is unfortunate enough to be issued a single C5,000 fine. As the city guards tend to extract more from successful traders, those at the upper end of the income scale also lose a considerable amount of their income to the city council and the pockets of the city guards. The daily taxes, regular tributes of C3,000 per month and one C5,000 fine translates into 33 percent of a C28,000 monthly income. This percentage increases if her goods are spoiled or stolen while in the custody of the city council. For instance, if a trader also loses half of a C10,000 stock of goods, the effective rate rises to just over 50 percent. A trader is not likely to be fined every month, yet two to three fines a year can devastate any savings a trader may have accumulated, dashing chances of establishing a stationary selling position, a prerequisite for substantial levels of both formal and indigenous credit.

Fortunately, the city council no longer controls prices. However, a considerable amount of waste and inefficiency is still introduced

[15]The daily tax is C40 or about $.10. The irony that trading on the street is illegal, yet taxable, is not lost on the street vendors. One such woman proclaimed that if the city guards were all fired, hawkers would then be able to save enough of their money to build their own market stalls and not have to trade on the sidewalk.

[16]Usually the fine is C5,000 (about $12), but if the trader is a repeat offender or if the volume of goods she trades is unusually large, the fine can be doubled or even tripled.

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by other restrictions on market activity. As valuable resources are diverted from the productive market sector to the unproductive bureaucratic sector, the potential of the local economy to enhance the financial prospects of the most marginal entrepreneurs is mitigated.

Unintended Consequences of Bureaucratic Intervention

While legal sanctions against street vending have the obvious and intended consequence of frustrating this sort of market activity, bureaucratic maneuvering often erects systematic, though unintended barriers to successful market interaction. Finally recognizing the deleterious effects of price controls, all was to be remedied as the city council began to rebuild the markets after 1983 when the ERP was under way. Yet, all was not remedied. The market traders were compensated with new stalls, but the city council could not rebuild the trust relationships which had developed over decades of face to face interaction among neighboring traders. Market women were given new stalls, but not the same neighbors. The potential benefits from forging new relationships have been dampened given the general atmosphere of uncertainty. No trader is sure when another similar occurrence will happen.

Since the inception of the ERP, other reasons have been found to relocate traders, either to make room for a parking lot (the result of a successful lobbying campaign by the taxi companies), or to thin out the market to help the flow of traffic. No matter what the motivation, the result is the same: the destruction of the credit and mutual assistance societies that had emerged over years of interaction with the same people. Further, such disruptions particularly frustrate elderly traders, such that they do not return to the new locations. This is a devastating blow to the indigenous credit institutions, as a vacuum of experience and trust is left, rather than a gradual transition of authority.[17]

Currently, the Accra city council is planning to spread the markets out to alleviate traffic problems in the most central part of the city. The criterion by which the city council decides who gets moved to the new location will be according to the size of the delivery trucks involved. For example, yams are delivered in large vehicles which block traffic, thus yam sellers will be removed to the new more distant location. Tomatoes, on the other hand, are delivered in

[17]The effects of these policies can be seen in the differences between the markets in Accra and Kumasi and other areas more distant from such political upheaval. The described indigenous institutions in Kumasi are more stable and offer more substantial opportunities for support than in Accra, where most of the political and bureaucratic maneuvering has taken place.

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smaller vehicles, so tomato vendors would be allowed to remain in the central markets. This proposal demonstrates the inherent danger of allowing market decisions to be made solely on the basis of bureaucratic concerns.

This is not to say that traffic congestion is not a problem in central Accra, but overriding market considerations is not the solution. If the campaign is successful, the move will once again wrench traders from their network of trust and support, and thereby undermine the evolved system of indigenous credit. If entrepreneurs anticipate the move and shift their behavior in response to such a policy measure (e.g., yam sellers may switch to selling tomatoes), this will in turn increase the costs and risks associated with buying and selling yam, an important dietary staple.[18] The solution lies not in overriding the market process, but rather, in allowing it to work. The congestion problem will be best addressed by a system of market, not state set prices for selling space. Below, I will return to the issue of privatization.

Lack of Scarcity-Indicating Prices for Selling Space

On any given day, a market trader could walk into the city council offices and acquire selling space within the market. According to the city council, many spaces are currently vacant. For C25,000 ($59), a trader can secure an assignment to a market stall. Yet, many street vendors will tell you that there are no available spaces in the market. Others will say that there are spaces available, but the prices are too high. When asked how much they would have to pay to acquire space in the market, they quote prices two to sometimes three times higher than the price quoted by the city council. This is particularly puzzling, given that during the previous year, the city council provided new market stalls at no cost to which street traders could move. However, the women stubbornly refused to stay and returned to trading on the street.

Was this a case of the hawkers acting irrationally or at the very least belligerently? Are city council officials simply lying when they say that spaces are available? Or are the market traders simply confused, not realizing that the stalls are available and less expensive than they think? The answer is "none of the above." The fact is that spaces are available in the market. Further, the city council did (unsuccessfully) attempt to move traders from the street by providing

[18]This proposed "solution" also reflects the male bias at the bureaucratic level. Only someone who has never done the shopping for the family at the end of a long day of selling in the market would see separating the items needed for the traditional daily meals across distant ends of the city as a solution.

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free selling space. Yet, the traders are not confused, nor was their response to the offer of free selling space irrational or simply belligerent. The confusion stems solely from the fact that the stall prices do not reflect relative scarcity or desirability.

As the state officially owns the market stalls, it is incapable of reflecting their true value in the price structure. The fact that some spaces are available at the prevailing rate, should not lead to conclude that the rent charged by the city council comes close to reflecting scarcity conditions. In charging a single rate, the city council assumes that a homogeneous good, "market stall space", is being offered. But not all market stalls are created equally. The market stalls span a wide heterogeneous array in terms of location, access to facilities, sanitary conditions, and customer appeal.

Some stalls are near the openings of the market and attract a significant amount of traffic. Yet, the same price will be charged for a stall which is tucked away in an obscure part of the market which sees little traffic. Some stalls are on a dirt surface, yet it will cost as much as another stall on concrete, which will attract customers even during the rainy season and will not ruin a trader's goods with mud stains. The case mentioned above, when hawkers were offered stall space at no cost only to return to the street, was again a situation where the selling space was inappropriately priced. In fact, the "free" selling space was placed in an obscure corner of the city and attracted little traffic. Thus, the zero price charged was simply too high, as the opportunities for profit were more abundant on the street.

Likewise, the differences between the accounts as to the prices and availability of selling space reflect, not confusion on the part of the traders, but the city council's inability to appropriately price heterogenous resources. Most street traders know that some stalls are available at the set price of C25,000. But they are quick to point out that the only stalls available at this price are in a poor location and will not attract customers. The prices that they quote which are two to three times higher than the official price are the prices in the secondary market. As a trader leaves the market, she will pass on the stall space at a price which reflects the true value of the resource.[19] However, the secondary market is officially illegal, and therefore

[19]Note that stall space in a good location is a valuable resource which is often passed from one generation to the next. A well placed market stall acts as both a source of venture capital for a daughter or niece expanding a business (or perhaps a granddaughter starting out), as well as a source of social security for the retiring trader. As an older women makes a gift of the space to a daughter, niece, or grand-daughter, she can expect some form of support (either financial or in-kind) from the recipient.

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ownership cannot be guaranteed if a stall is acquired through a black market transaction.

It is not being argued that the city council officials are simply too simple-minded to see the obvious. In fact, on the surface, the market stalls do seem to all look alike. If we only look at their structure and design, they are more alike than different. Their heterogeneity is only manifest as the market process unfolds. In other words, it is only through market activity that one can discover what the true value of such resources are. Thus, merely encouraging greater attentiveness on the part of the city council will not produce a price structure which appropriately reflects relative scarcity. As it is absent a mechanism for discovering what the value of these resources are, the bureaucratic process has no means of acquiring this sort of particularized knowledge. Prices which reflect the relative scarcity and desirability of a resource can only be discovered through a market process.

Policy Implications

Full scale privatization of the marketplace stalls and shops would solve or at least mitigate the most debilitating obstacles facing indigenous trade. By affording the occupants of market stalls private ownership rights, the pricing and allocation of stall space would fully reflect market conditions rather than arbitrary state set prices. Private ownership would also afford the opportunity to un-bundle the resource by allowing owners of stalls to rent to more than one occupant. Traders could then either divide the space, split the selling day or week or invoke a combination of the two. This would reduce the per person cost of acquiring space in the market and thus reduce the crowding on the street.

Privatization would also open the way for private developers to erect new structures which would likewise reduce the level of crowding. A private developer would price the spaces in a new structure according to market conditions and not need to rely on a rigid set price structure as is the case under municipal management. Further, by allowing private developers the opportunity to erect new markets, they will have to compete for occupants, not only by pricing the stall space according to market conditions, but through services as well. Once entrepreneurs have a choice as to who they rent or buy from, as opposed to having to rent from the state, the market will reward those developers who provide services seen as essential to the marketplace, such as toilet and locker facilities, security, or shelter from

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the rain; all cited as serious drawbacks to the current marketplace environment.

This is not to say that all developments will necessarily provide these services. Some may offer only the barest elements of a marketplace structure. But the prices of such stalls would then reflect the lack of services and would allow the opportunity for those on the lower end of the income scale to establish a fixed location in order to trade. This is an essential move for the most marginal of the traders, as this is a clear indication of a person's credit worthiness to a potential lender (either to formal banking institution or indigenous sources of credit). Thus, an array of quality will allow for an array of prices, such that the move from street vending to a fixed location is not such a cataclysmic jump.

Private rather than municipal management of the marketplace is likely to result in fewer cases of full scale upheaval, and the resulting loss of valuable credit and mutual support networks. The allocation of stall space and location will be based on market conditions, not political or bureaucratic considerations. If a marketplace is the most profitable venture, political maneuvering will not override market conditions as they do in the case of municipal management. If market conditions were to shift dramatically, however, at least in the private context, the traders would have the option of establishing themselves in a new space as a block, by renting a row of stalls, for instance. This option is a virtual impossibility under current municipal management. Further, in the private context, there is the opportunity for long term leasing and purchasing arrangements to emerge, such that traders would have to be compensated if they are to be enticed to move; again, an option which is clearly not available under municipal management.

Thus, privatization efforts will have both the expected benefits of rational market pricing and allocation of resources, but it will also have some not so obvious benefits as well. Private development would supply new market space at prices which reflect scarcity conditions. The array of rental rates or prices likely to emerge would provide opportunities for the most marginal traders to establish a fixed location and therefore access to greater sources of credit. The private context would allow the un-bundling of resources, providing even further opportunities for the small scale entrepreneur. Perhaps most importantly, by fostering stable property rights, privatization efforts would support and enhance the performance of indigenous credit and mutual assistance networks.

Clearly the economics profession is aware of the advantages market coordination affords over bureaucratic control, yet sound policy

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conclusions seem to consistently elude us in third world contexts. The arguments made here suggest that we have missed opportunities for promoting economic development because we have ignored the cultural specificity in which institutions emerge. Specifically, we have tended to assume that one model, the Western model, of a credit is the only path towards development. Rather than forcing West African culture into the mould of Western institutions, we are likely to meet with more success if we advocate policies which allow indigenous institutions to work to their full potential.

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School Choice: The Essential Reform

Herbert J. Walberg and Joseph L. Bast

Introduction

Should parents be allowed to choose the schools their children attend? When parents choose nonpublic schools, should tax dollars go to the chosen schools or continue to fund the schools that failed to win their approval? These questions are easy to ask, yet their answers are difficult and have become the subject of fierce national debate.

Educational choice is not an untried concept. Many states and cities allow parents to choose among public schools within their districts of residence, and it appears inevitable that these opportunities will be extended to allow *inter*district public school choice in the next few years. Indeed, eight states already allow parents to choose public schools outside their districts of residence.

Comprehensive educational choice programs, such as those available to some students in Wisconsin and Vermont, extend choice to *private* schools. Funds that otherwise would go directly to public schools are given instead to parents or their chosen advocates in the form of certificates or scholarships, or as deposits to Education Savings Accounts (Bast and Bast 1991; Blum 1958, 1967; Coons and Sugarman 1978a, 1978b, 1992; Friedman 1962). Parents can redeem education certificates or make withdrawals from the accounts to pay for tuition at participating public and private schools or, with the assistance of education service coordinators, purchase education programs from multiple providers.

Comprehensive educational choice constitutes a partial privatization of education. Public funding of education remains intact, and with it public oversight of the kinds of schools and instruction that

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qualify for public support.[1] Still, such a program of choice represents a significant departure from the usual method of financing and managing public schooling. It raises questions regarding the public nature and benefits of education, the ability of government to produce quality services, and the depth of the state's commitment to using its power to tax to finance education. It could also signal further movement toward privatization at some future date (Lieberman 1989, 1993; Bast and Wittmann 1991).

The public increasingly tends to favor comprehensive educational choice. Gallup Polls conducted in 1981, 1983, 1985, and 1986 asked if the respondent supported an education certificate, or voucher, system that would allow parents to choose nongovernment schools. In each year, more replied "yes" than "no" (Kirkpatrick 1990). Seventy percent of respondents to the latest (1992) Gallup Poll supported comprehensive educational choice. Support among Blacks and Hispanics, who currently have the least or worst choices of failing big-city schools, was a remarkable 86 percent (*Wall Street Journal*, 21 September 1992).

In opposition to comprehensive educational choice stands the public school lobby, consisting of teachers union officials, organized groups of school boards, superintendents, and others with a stake in the status quo. The public school lobby has cloaked itself in powerful symbols such as social democracy, equal opportunity, and national unity. Nevertheless, choice opponents have suffered some high-profile defections from their ranks. Wisconsin State Representative Annette "Polly" Williams, a black liberal Democrat, coauthored and helped pass Milwaukee's landmark private school choice program and now travels the country speaking in favor of educational choice. The usually liberal Brookings Institution in 1990 published *Politics, Markets and America's Schools*, by John E. Chubb and Terry M. Moe, who suggested that their colleagues "would do well to entertain the notion that choice *is* a panacea." They go on to write (Chubb and Moe 1990: 217):

> This is our way of saying that choice is not like the other reforms and should not be combined with them as part of a reformist strategy for improving America's public schools. Choice is a self-contained reform with its own rationale and justification. It has the capacity all by itself to bring about the kind of transformation that, for years, reformers have been seeking to engineer in a myriad of other ways.

[1]Some of the harshest criticism of vouchers comes from persons seeking more complete privatization of education (Chodes 1991, Gottfried 1991, Boaz 1993).

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It is likely that, over time, the battle will continue to go badly for the opponents of choice. The National Education Association, once a foe of even public school choice programs, has been compelled to moderate its opposition to choice and now is reduced to using force and intimidation to keep choice proposals off the ballot in California, Colorado, Pennsylvania, and Florida. Other socialist enterprises and economies around the world are collapsing or being sold. Voices for privatizing America's biggest government-run enterprise—education—are getting louder and are coming from ever more respected people. People like Chris Whittle, Benno Schmidt, William Bennett, and Nobel laureates Milton Friedman and Gary Becker are difficult to ignore.

When American Federation of Teachers President Albert Shanker claimed that "the evidence shows that vouchers would not encourage excellence or ensure a better education for poor children" (Shanker 1991: 5), his self-interest was painfully apparent. But was then-President George Bush right when he said that "We can encourage educational excellence by encouraging parental choice, [which] will create the competitive climate that stimulates excellence" (Bush 1991: 3)? What evidence is there that choice is, indeed, the essential reform?

Evidence from Educational Choice Experiments

Empirical evidence from experimental programs involving educational choice is very slim, but nonetheless worth reviewing. Milwaukee, Wisconsin, and the state of Vermont have choice programs that extend to private schools. Alum Rock, California, and the state of Minnesota have experimented with public school-only choice programs. And Minnesota has a tuition tax deduction for public and private schools.

Alum Rock, California

Beginning in 1970, the federal government's Office of Equal Opportunity (OEO) conducted an experiment designed to test the effects on student achievement of contracting for instruction, incentive-based agreements, and educational choice (Capell 1981; Lieberman 1989; Witte 1992: 210). Although the experiment was originally intended to include private schools, none ever participated. Parents were given vouchers with which to choose among competing public schools, but the schools were protected from the consequences of competition in numerous ways, including job guarantees for the staff of schools suffering declining enrollments and enrollment limits on the most popular schools. (In a real market, this would be analogous

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to capping sales of popular cars and insisting that some consumers buy less-preferred models.)

A wide range of experiments in instructional methods and the size of schools took place during the Alum Rock project. For example, some 45 special programs operated in 13 schools involving such innovations as open classrooms and combined grade levels. Teachers and principals were given greater autonomy, and some degree of parental choice was created. But comprehensive educational choice was not part of the bigger experiment.

Evaluation of the Alum Rock experiment was hindered in many ways. Several innovations were being tried at once, making it impossible to isolate the causes of improved or retarded student performance. The duration of several parts of the experiment, particularly the contracting-out portions, was too short to allow for meaningful evaluation. The OEO was subjected to heavy criticism for its failure to plan to experiment in a way that would make accurate evaluation possible (Lieberman 1989: 255).

Evaluations of Alum Rock that *were* conducted found no apparent effect on reading achievement, students' perceptions of themselves and others, or their social skills (Capell 1981). Lieberman (1989: 98) quotes a 1973 General Accounting Office study of the contracting-out portion of the experiment that concluded, "because of a number of shortcomings in both the design and implementation of the experiment, it is our opinion that the question as to the merits of performance contracting versus traditional educational methods remains unanswered."[2] The Alum Rock experiment, in short, produced no usable data concerning the merits either of privatization (contracting-out) or educational choice.

Minnesota Tax Deductions and Public School Choice

Since 1955, the state of Minnesota has allowed parents to deduct education expenses, such as tuition and transportation, from their state income taxes. In 1992, deductions of up to $650 for elementary students and $1,000 for secondary students were allowed (Nathan 1989a: 8); private schools, including religiously affiliated schools, are allowed to participate in the program.

Tax deductions for tuition lower the financial barrier facing parents who might choose private schools for their children, and so represent a way of encouraging educational choice and competition among

[2]General Accounting Office (1973) *Evaluation of the Office of Economic Opportunity's Performance Contracting Experiment.* Report to the Congress by the Comptroller General of the United States, B-130515, Washington, D.C.

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public and private schools. In Minnesota, however, the size of the tax deduction is too low to influence parents' decisions regarding selection of schools. The Minnesota income tax is 6 percent for persons reporting incomes of $13,000 or less and 8 percent for incomes over $13,000.[3] At the 8 percent tax level, a $1,000 tuition payment qualifies a family for only $80 in tax relief. Not surprisingly, studies of the Minnesota tax deduction program have found that it has little influence on parents' selection of schools (Darling-Hammond and Kirby 1985).

Between 1985 and 1988, the Minnesota legislature authorized several additional educational choice programs (Nathan 1989a: 12–14). The two most popular programs, the High School Graduation Incentives and Area Learning Centers programs, permit students between the ages of 12 and 21 who have not succeeded in one public school to attend another public school outside their district. Over 17,000 students took advantage of these two programs in the 1990–91 school year. The next most popular program—the Postsecondary Options program—allows 11th and 12th graders in Minnesota public schools to attend colleges, universities, and vocational schools. About 6,700 students participated during the 1990–91 school year (Schroeder 1993).

Most relevant to the discussion here, however, is Minnesota's state-wide public school choice program enacted in 1987 and implemented in the 1987–88 school year. Under the Enrollment Options Program, parents of children between the ages of 5 and 18 may transfer their children to public schools outside the district in which they live (Nathan 1989a: 14). Public funds follow the student to the new school. Parents pay for transportation of their children to the boundary of the receiving district, whereupon the receiving district takes responsibility for transporting the child to his or her school.

In the 1989–90 school year, 3,218 students of 731,455—less than one-half of one percent—took advantage of the Enrollment Options Program (Witte 1991a). In the 1990–91 school year, the number of students participating in the program increased to over 5,900 students—roughly three-quarters of one percent of the state's total enrollment that year.

Despite the low level of public participation in the program, opinion polls indicate that the Minnesota open enrollment program is popular, with some 63 percent supporting the plan in a 1988 poll (Nathan 1989b: 208). One hundred percent of families with students

[3]An additional rate of 0.5 percent is collected on certain upper-income classes.

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participating in the program report that they are satisfied with it (Nathan 1989a: 14).

The problem with drawing any lessons from the Minnesota program is that, for all its significance as the nation's first state-wide open enrollment program, the actual impact of the program on schools and students is likely to be small and difficult to measure. In the words of one observer, the Minnesota plan "appears to be radical and gains enormous press but in practice ruffles few feathers and costs almost nothing" (Witte 1991a: 14).

Nevertheless, the Enrollment Options Program has had a dramatic effect on a few individual school districts in the state. In Brooklyn Center, for example, 390 of the district's 1,659 students open-enrolled from outside the district. District superintendent Doug Rossi reports "the district gains more than $1 million in revenue per year and employs 16 to 20 more teachers because of open enrollment" (Schroeder 1993: 6). On the other hand, when 10 percent of the Herman school district's 261 students decided to open-enroll out of the district, officials nearly voted to close the high school and bus students to another district for the 1993–94 school year. The motion failed on a tie vote (Schroeder 1993: 7).

These anecdotes suggest that, in a few years, the Minnesota open enrollment program could begin producing measurable results for large numbers of students and schools. Until then, it is not a significant source of empirical data on the benefits or pitfalls of choice.

Milwaukee's Parental Choice Program

Unlike the Alum Rock and Minnesota experiments, the Milwaukee Parental Choice Program is a potentially valuable source of empirical research on the effectiveness of educational choice. The program was enacted in 1990, the result of a remarkable alliance between Wisconsin State Representative Annette "Polly" Williams, a liberal Democrat representing Milwaukee's inner city, and Wisconsin Governor Tommy Thompson, a conservative Republican. The program allows up to 1 percent of students in the Milwaukee Public School system to receive state aid of approximately $2,500 per student to attend private schools. The program is available only to low-income students, and sectarian schools are not allowed to participate.

Although often called a voucher program, the Milwaukee Parental Choice Program does not give guardians certificates or vouchers with which to pay tuition. Instead, funds go directly to schools that sign up for the program and report qualified student enrollments. The program is limited in other ways: no more than 49 percent of a private school's enrollment may consist of pupils attending the school with

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state aid, and only newly enrolled students or students who qualified for aid in the previous year are eligible for the program. Participating schools may not charge tuition in excess of the $2,500 state grant, and they are required to submit reports on academic achievement, daily attendance, percentage of dropouts, percentage of suspensions and expulsions, and evidence of parental involvement in the schools' programs. Thus, they share some of the regulatory and reporting burdens of public schools, but must get by on about half of the funding public schools receive.

The decision to exclude sectarian schools means there were relatively few schools in the city eligible to participate in the program. Enrollment in September 1990 stood at 341 in seven schools; another 217 students were refused admission because of space limitations. In September 1991, enrollment was up to 562, but participating schools had fallen to six due to the closing of one school (Juanita Virgil Academy). One hundred thirty-three students were turned away for lack of space in 1991.

John Witte, professor of political science at the University of Wisconsin, completed the first in-depth study of the Milwaukee Parental Choice Program (Witte 1991b). His generally favorable evaluation is made especially significant by the fact that he approached his investigation highly skeptical of the program; indeed, the Wisconsin Policy Research Institute complained the program evaluation was "mismanaged" because Herbert Grover, the state's Superintendent of Public Instruction, "chose an evaluator who has been critical of choice" (Mitchell 1992: 2).

Witte's evaluation, while not without criticism of the program, nevertheless can be considered a firm endorsement of educational choice. While the program is too new for a researcher to draw strong conclusions, several of Witte's findings are notable. He found that, "rather than skimming off the best students, this program seems to provide an alternative educational environment for students who are not doing particularly well in the public school system" (Witte 1991b: iv). Just 25 percent were at or above the median in reading and 36 percent in math, vs. 35 percent and 43 percent, respectively, for all Milwaukee Public Schools (MPS) students. Moreover, "Choice families appear to be considerably less well off than the average MPS family in terms of employment, income, and being on public assistance or AFDC. They are also less likely to come from two-parent families" (Witte 1991b: 5).

Regarding student achievement, Witte found little change in test scores that could be attributed to the choice program. Choice students improved slightly relative to a national population on reading

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but fell slightly in mathematics; on the same tests, MPS and low-income students declined slightly in both areas. Reports Witte (1991b: 19):

> If there is any firm conclusion from these results, and we are not sure if there is much of one, it is that when students begin as far behind as the students apparently did in the first year of this program, seven or eight months will not produce dramatic changes in test scores.

Though they came from poorer socioeconomic backgrounds, Witte found that choice students had slightly higher attendance rates than their MPS counterparts. He also found evidence that choice was motivating students and parents: "Student attendance, parental attitudes toward choice schools, opinions of the choice program, and parental involvement were all positive" (Witte 1991b: 23). Involvement by choice parents at home and at school was higher in "every category of parental involvement except belonging to a parent/teacher organization," with the exception explained by the absence of formal PTO-type organizations at some of the choice schools (Witte 1991b: 16). Parental satisfaction with the choice schools is very high, "On every item, not only are the choice parents considerably more satisfied than MPS parents, they are much more satisfied than they were with their prior (public) school" (Witte 1991b: 19–20). Witte's description of the schools helps explain why parents are so happy (Witte 1991b: 17):

> The schools were more than adequate educational institutions. In general, they have elaborate and refined organizational structures that heavily involve parents in the schools. The students have a positive attitude toward their environment and teachers. Classes that we observed were generally small, with a high proportion of time spent on task. The curricula in the schools were relatively rich in terms of arts, music and dance, languages, and computer use. The cultural emphasis in several of these schools was distinct and seemed positive. And most of the instruction we observed was very similar in substance and style to instruction in ordinary public schools.

Witte concludes his report by recommending that the legislature remain committed to the principle that "parents can best exercise accountability and determine the adequacy of educational outcomes by making free choices among schools" (Witte 1991b: 24).

Comment

At just two years of age, the Milwaukee Parental Choice Program can hardly be asked to provide sufficient evidence to end the educa-

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tional choice debate. And indeed, the short duration and small size of the program have produced unreliable and ambiguous findings regarding student achievement—arguably the one measure of success that outweighs all others combined. But already the Milwaukee experiment has answered some critics of educational choice.

- A carefully designed choice program need not "skim" the best students from the public schools, leaving the children of less-sophisticated parents behind in even worse learning environments. In fact, choice can have just the opposite effect, benefiting the students who need help the most.
- A choice program can inspire and motivate students and their parents. The private schools participating in the Milwaukee program involved parents much more extensively in school activities than did their public school counterparts. Parents and students responded by valuing the schools and having more positive attitudes toward the learning process.
- The private schools in a choice program will not all be perfect—witness the closing of Juanita Virgil Academy —but they tend to be "more than adequate educational institutions" that create an environment of close cooperation and trust among teachers, students, and parents. Many parents and educators will recognize "the cultural emphasis" that Witte discerned as a very valuable component of a successful classroom, and something too often missing in public schools.

Vermont

Vermont has had a little-known voucher program for over one hundred years, involving thousands of students each year (McClaughry 1984, 1987; Bryan and McClaughry 1989; Cobb 1992: 163). Like the Milwaukee program, it sheds some light on how educational choice works in practice.

Approximately 95 of Vermont's 246 communities have no public high schools. They choose instead to pay tuition for their high-school age students to attend either private high schools or public high schools operated by another town. Thirty-five towns offer this choice to K-6 grade students, either because they have no public elementary schools or because the public schools do not offer every grade. This program originated in 1869 as a way to enable small and geographically distant communities around the state to provide high school education for students without incurring the expense of building their own public schools. Minimum tuition amounts are set at the average cost of tuition at a Vermont public high school, with parents

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usually responsible for paying any additional tuition charges and transportation.

Prior to a Vermont Supreme Court ruling in 1961 (*Swart v. South Burlington*, 122 VT 177, 167 A2d 514, 1961), sectarian schools were allowed to participate in the choice program; since that ruling, Catholic and fundamentalist Protestant schools have been excluded. The state requires private schools participating in the program to offer specific courses, maintain attendance records, assess progress regularly, have a public statement of school objectives, maintain a faculty with adequate training (though not necessarily certified), secure formal support for the United States Constitution and laws by the faculty, immunize students, and submit to periodic approval by the state.

Has the Vermont program worked? We are aware of no attempt to compare the achievement growth of students in Vermont who use versus those who do not use the choice program. Anecdotal descriptions invariably mention strong parental support for the program and popular opposition to attempts to end it. Bryan and McClaughry, for example, report that "educators may disapprove, but from all accounts parents love it. In some cases parents have chosen to move into a town simply because it gives them the right to choose their children's school" (Bryan and McClaughry 1989: 195).

Given the great variety of schools that participate—parents are free to "add on" to the tuition with their own funds, and students can even attend schools outside the state—and the self-selective nature of the program, an evaluation of Vermont's system would be difficult to perform. However, the very fact that the program is so little known outside the state suggests that the many disasters predicted by opponents of vouchers have not come to pass. This program has worked quietly for over one hundred years, providing an efficient and popular solution to the problem of low population densities.

Vermont ranked 6th in the nation in 1989 in SAT scores, 7th in percent of high school graduates taking the test, and 13th in high school graduation rate (U.S. Department of Education 1990). Once a relatively low-income state, ranking 35th in personal income per capita in 1980, Vermont had caught up with the rest of the nation by 1989, ranking 25th. Which of these statistics, if any, can be attributed to Vermont's choice program cannot be known, but enough students participate in the program (approximately 25 percent of all high-school age students) that the program must be having some measurable effects.

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The experience in Vermont, like those in Alum Rock and Milwaukee, is a highly imperfect test of educational choice. Critics of choice will point to the state's rural character, racial and ethnic homogeneity, or some other features that might make it difficult to apply the Vermont system to other states or communities. Still, what we know of this system's operation tends to fall into the "pro-choice" column of the debate.

Comparisons of Public and Private Schools

While no large-scale experiment with government-funded private school choice has been conducted, an unintended choice experiment has been going on for many years involving millions of students. Side-by-side with public schools with assigned enrollments are private schools enrolling some six million children each year. These are schools of choice in the strictest sense: every child is in a school deliberately chosen by his or her parents. By comparing the organization and outcomes of public and private schools, we can discern some of the consequences of choice.[4]

The pioneering research on public and private school comparisons was conducted by James Coleman, Thomas Hoffer, and Andrew Greeley (Coleman and Hoffer 1987; Greeley 1981). Coleman and his colleagues helped assemble and analyze the *High School and Beyond* study, a panel study that tracked sophomores from 1980 to their senior years in 1,015 public and private high schools. They found that sophomore students attending Catholic high schools had achievement levels 2.4 grade equivalents above those of government school students.[5] After controlling for socioeconomic background, they found a difference in achievement levels about half as great, a still-considerable difference.

Critics pointed out that Catholic school students tended to start at higher levels of achievement than public school students, so Coleman measured the *growth* in student skills instead of the *level* of

[4]Myron Lieberman has pointed out the danger of viewing the current private school marketplace as a genuine market at all. Most private schools are established to allow religious instruction to take place, and most parents of private school students report that religious instruction or "values" in the curriculum are their primary motivation for choosing a private school. The relative scarcity of for-profit and non-sectarian schools, due to the competitive advantages held by publicly funded public schools, means usual market forces are absent or at least suppressed in the private school arena (Lieberman 1989).

[5]Coleman and other researchers generally exclude private high schools other than Catholic schools from their analysis due to the small number of such schools and problems interpreting their test scores.

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achievement. Once again, significant differences between Catholic and public schools were documented, this time with Catholic schools achieving a full-year's extra achievement in a two-year period.

Still the critics were not satisfied, contending now that unmeasured differences—perhaps discipline in the home, or religious conviction—that did not affect sophomore achievement nevertheless were affecting the growth of achievement during the following two years of schooling. Perhaps Catholics tend to perform better in school than non-Catholics even after controlling for the usual socioeconomic variables, and thus Catholic schools (which are assumed to be more attractive to Catholic students) draw the best students away from the local public schools.

Coleman has responded to this latest hypothesis by comparing the achievement of Catholic students attending public schools near a Catholic private school to the achievement of Catholic students attending public schools that are not near Catholic schools (Coleman 1990). Coleman finds that the achievement of the two groups of Catholic students is virtually the same, suggesting that the Catholic school is not "creaming" the best Catholic students away from the public schools.

A final criticism of the Coleman thesis is that the unexplained difference in student achievement between public and Catholic schools, while statistically significant, is so small as to not justify changing the organization of schools (Haertel, et al. 1988; Levy 1986; Witte 1992). According to *High School and Beyond* data, the differences in test scores between sophomore and senior years for most students, whether in public or Catholic schools, is very small: 0.15 standard deviations per year for public schools, and 0.18 for Catholic schools. The difference between the two, just 0.03 standard deviations per year, is hardly so large as to support the contention that one school system is significantly better than the other. These numbers suggest that researchers should be asking why students learn so little in high school, regardless of whether they are in Catholic or public schools.

Perhaps the most economical response to this latest criticism is to step back from the statistics and ask *why* we would expect Catholic schools to outperform, or even perform as well, as public schools. Catholic schools spend, on average, just half as much as public schools.[6] Even if the performance of Catholic school students, after being controlled for socioeconomic background and everything else

[6]Robert J. Genetski (1992) estimates that public school costs averaged $4,841 in 1990 while Catholic schools averaged $1,902.

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discussed above, only equals, rather than exceeds, the performance of public school students, Catholic schools are still *twice as cost-effective* as public schools. This, certainly, is a finding with public policy implications.

Coleman has a plausible explanation for why we can expect Catholic schools to outperform public schools. According to Coleman, while the youth revolution of the 1960s and 1970s led many public schools to weaken their curricula and offer growing lists of easy-to-pass elective courses, private schools generally did not lower their academic standards (Coleman 1990: iii). Catholic school students with comparable backgrounds are 7 percent more likely to have taken biology, chemistry, or physics, and 13 percent more likely to have taken specified mathematics courses, than their public school counterparts. Since it is well established that time on task is a major factor in raising student achievement, it should follow that Catholic school students will outperform public school students.

The ability of Catholic schools to retain their strong curriculum derives, according to Coleman, from the fact that they are private, community-based institutions. Such institutions create social capital that parents and educators can use to help support their children during the difficult years of growing up. Coleman explains (1990: iii):

> The students were in school by choice, and families were paying, giving parents an additional weapon in the intergenerational conflict. Second, Catholic schools had few financial resources with which to add courses to meet a new demand. Third, Catholic schools, with a voluntary clientele, could define their mission less broadly. Probably of greatest importance, however, was the connection among parents, and between parents and school. This provided support for parents in resisting the youth revolution; it formed an adult community, and provided for each pair of parents what might be called "social capital" to aid in resisting the revolution.

This sociological explanation for differences in public and private student achievement levels has been reinforced recently by political scientists John Chubb and Terry Moe. Working with an expanded version of the *High School and Beyond* database, Chubb and Moe (1990) find that *how* schools are organized plays a major role in how much and how quickly students learn, a finding supported by other researchers. But Chubb and Moe go on to contend that private schools are more likely than public schools to be organized effectively. They reason that public schools are encumbered by hierarchical and bureaucratic structures that necessarily accompany political oversight, whereas private schools are able to vest most authority

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directly in schools, parents, and students. Thus Chubb and Moe have become vocal proponents of educational choice.

One final note regarding comparisons of public and private schools may be worthwhile. A recent survey article published by the World Bank looked at studies of public and private school performance in Colombia, the Dominican Republic, the Philippines, Tanzania, and Thailand (Jimenez, et al. 1992). Each study controlled for student socioeconomic background, and two (the Dominican Republic and Thailand) used panel data similar to the U.S. *High School and Beyond* study. With just one exception—math instruction in the Philippines, where public and private schools tied—private schools outperformed public schools on student achievement. When the researchers incorporated per-pupil spending to estimate cost effectiveness, they found that private schools were more cost effective in every case. Table 1 summarizes these findings.

Comparing public and private schools sheds some light on the question of whether educational choice is an essential part of creating successful schools. But the light is not nearly so bright as we might hope.

- Students attending Catholic schools learn more than students attending public schools, even after socioeconomic background is taken into account. How *much* more they learn, though, is debatable. The difference may not be enough to justify changing the organization of schools.
- Catholic schools educate their students at a fraction of the cost of public schools. That they are able to at least match the performance of public schools, while spending so much less, indicates that they probably have lessons to teach us.
- The governance structures of private schools and the incentives facing parents of children attending private schools are more likely to produce strong curricula and the "social capital" that families need to pursue educational excellence. These structures and incentives do not arise without cause. They arise when students voluntarily choose a school and parents make a commitment to support that school.

Research on Effective Schools

Research on the qualities of effective schools provides another opportunity to measure the effects of educational choice. There is an emerging consensus on the qualities of an effective school: strong educational leadership by the principal, high expectations, parental involvement, and a sense of teamwork shared by teachers and

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TABLE 1

RELATIVE AVERAGE COST AND EFFICIENCY OF PUBLIC AND PRIVATE SCHOOLS

Country	(1) Ratio of Private to Public Effectiveness	(2) Ratio of Private Cost to Public Cost	(3) Ratio of Relative Effectiveness to Relative Cost
Colombia	1.13	0.69	1.64
Dominican Republic	1.31	0.65	2.02
Ordinary	1.47	1.46	1.01
Prestigious	1.00	0.83	1.40
Philippines			
Math	1.18	0.83	3.17
English	1.02	0.83	1.20
Pilipino	1.16	0.69	1.71
Tanzania	2.63	0.39	2.62
Thailand			

SOURCE: *World Bank Policy Research Bulletin*, January–February 1992: 4.

administrators (U.S. Department of Education 1986: 45; Schultz 1983; Lanier 1982; Walberg, et al., 1988: 89–103). Effective schools often exist side-by-side with schools that, though equally or better funded, exhibit few of the traits known to accelerate learning.

The role of parental involvement in schools has been especially well-studied and found to be a major influence on student achievement. Deliberate cooperative efforts by parents and educators to modify academic conditions in the home have an outstanding record of success in promoting achievement. In 29 controlled studies of the past decade, 91 percent of the comparisons favored children in such programs over nonparticipating children. The average measurable effect of these parental involvement programs was twice that of socioeconomic status, and some programs had effects that were ten times as large. Since few of the programs lasted more than a semester, the potential for programs providing sustained parental involvement is great (U.S. Department of Education 1986: 19; National Conference of State Legislatures 1991: 21; Bast and Wittmann 1991).

Is allowing educational choice more or less likely to create schools that have the characteristics of effective schools? The empirical record in this regard is clear: Catholic school teachers are more likely than public school teachers to report satisfaction with principal leadership (59.1 percent vs. 49.8 percent), staff cooperation (67.9 vs. 52.4), teacher control over school and classroom policy (81.1 vs. 65.9), and overall teacher morale (84.4 vs. 74.1) (U.S. Department of Education 1987: 74).

Private schools also have higher expectations than public schools, as indicated by the number of years of coursework required for high school graduation. Private high schools in 1985–86, for example, required an average 2.8 years of mathematics vs. 1.9 years required by public schools. In science, private schools required 2.5 years vs. 1.8 for public schools; in English, 3.9 years vs. 3.8 years; and in social sciences, 3.1 years vs. 2.8 years (U.S. Department of Education 1987: 85).

Research by Coleman and the recent experiences with the Milwaukee Parental Choice Program suggest that private schools do a significantly better job encouraging parental involvement, too. Mary Anne Raywid also has reported that educational choice promotes parental involvement and the other characteristics of effective schooling. She writes (Raywid 1991: 18):

> There is abundant evidence that public school parents want choice; that they are more satisfied with and have more confidence in schools that provide it; that parent choice increases the commitment and cohesion within schools extending it; and that these attributes combine to improve school quality and make schools more effective.

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Chubb and Moe linked the absence of choice in education and lower levels of parental participation when they wrote (Chubb and Moe 1990: 34):

> Lacking feasible exit options, then, whether through residential mobility or escape into the private sector, many parents and students will "choose" a public school despite dissatisfaction with its goals, methods, personnel, and performance. Having done so, they have a right to try to remedy the situation through the democratic control structure. But everyone else has the same right, and the determinants of political power are stacked against them. Democracy cannot remedy the mismatch between what parents and students want and what the public schools provide. Conflict and disharmony are built into the system.

State governors in the United States recognized how compulsory attendance at assigned schools discouraged parental involvement in their 1986 report on education (National Governors Association 1986: 67):

> Too often, parents of students in the public school system recognize that they have no choice, and they reason that they have no responsibility. They assume that a societal institution called public school in their neighborhood has a monopoly on the education of their children. Our model of compulsory, packaged education, as it now exists, is an enemy of parental involvement and responsibility simply because it allows no choice.

The strong tendency of private schools to better reflect the characteristics of effective schools than do public schools, combined with a strong theory linking choice to the adoption of these characteristics, is evidence of the benefits of allowing parents to choose. This evidence, while appearing to be less direct or convincing than test score data, may actually be stronger, as it does not rely on questionable testing methodologies and difficult-to-control-for background factors affecting student achievement. In any event, it adds to the body of evidence we have that choice, where it is already exercised, results in superior schools and learning environments.

Conclusion

The definitive test of educational choice has not been conducted, and probably never will be. Inaccuracies in testing are probably sufficiently great that it would be a mistake to base major policy decisions on the answers to tests administered to a small number of randomly selected students. Every choice experiment will be haunted by questions of selection, out-of-school influences, and difficult-to-quantify differences in teaching styles, student aptitudes,

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and the influences of peer groups. For these reasons, it is probably necessary, as well as wise, to base our evaluation of educational choice on broader evidence.

The limited choice experiments taking place in Minnesota, Milwaukee, and Vermont give us some assurance that choice programs are not disruptive, expensive, or a source of social inequality. That comprehensive educational choice extended to private schools can work in two vastly different environments—a largely minority inner-city, and a largely rural and nonminority state—is significant.

That private schools, both in the United States and abroad, are more cost-effective than public schools has been demonstrated convincingly by many researchers. This finding is consistent with research on a wide range of other services that have been contracted-out to private companies or otherwise privatized. If choice could enable us to raise the efficiency of existing public schools to the level of existing private schools, we could achieve current student achievement levels at half the cost, or perhaps twice the current levels of achievement at current levels of investment.

Schools that must compete for the loyalty of students and parents seem to find ways to organize themselves for success. Research on the characteristics of effective schools, and empirical investigations of the schools that have these characteristics, tell us that schools of choice are more likely to succeed than today's public schools based on forced assignment. This, too, is a reassuring finding.

Allowing students to attend sectarian or independent private schools supported by public funds is considered a radical idea in the United States. Japan, however, has a large private sector for upper-secondary and tutoring schools. Western Europe has long publicly funded religious and non-sectarian private schools. As few as three dozen parents are required to start a new school, eligible for state funds, in Denmark and The Netherlands. In these nations, the consumers of educational services are sovereign. Their empowerment is a major reason why their educational systems, while less well funded than our own, nevertheless routinely and easily outperform our own.

For over 100 years, Americans have attempted to deliver high-quality education through taxation, elected school boards, and geographic assignment of students to schools. Most other countries have pursued a different method of organizing schools, one that allows schools to compete for parents and students armed with the power to choose. Quite frankly, schools in other countries, and even the small and under-funded private school market in the United States, work better than do our public schools. We rely on markets in the

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United States to provide the food we eat, the clothes we wear, and the houses that shelter us. It is time the education community paid more attention to the markets that deliver these essential goods to us so reliably and efficiently. And it is time, too, for us to admit that our educational system, based on so different and outdated a model, will not meet our needs and expectations unless it is fundamentally changed.

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COMMUNICATIONS

The Economics of Minimum Wage Legislation Revisited

Richard V. Burkhauser and T. Aldrich Finegan

Introduction

In his seminal article "The Economics of Minimum Wage Legislation" (1946) George Stigler used what are now standard resource misallocation and loss of employment arguments to criticize the minimum wage. He wrote (1946: 358):

> The minimum wage provisions of the Fair Labor Standards Act of 1938 have been repealed by inflation. Many voices are now taking up the cry for a higher minimum. . . . The popular objective of minimum wage legislation—the elimination of extreme poverty—is not seriously debatable. The important questions are rather: (1) Does such legislation diminish poverty? (2) Are there efficient alternatives? . . . Some readers will probably know my answers already ("no" and "yes," respectively); it is distressing how often one can guess the answer given to an economic question merely by knowing who asks it.

Over four decades of empirical studies leave no doubt that increases in the minimum wage do reduce employment to some extent.[1] Yet by most counts, the number of lost jobs is trivial in the aggregate. Only for teenagers are statistically significant negative effects on employment consistently observed. Even for this group, we doubt

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[1]See Charles Brown, Curtis Gilroy, and Andrew Kohen (1982, 1983) and Brown (1988) for detailed reviews of this literature and Clifford Thies (1991) for a history of early minimum wage laws.

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that the losses are large enough to end public support, although concern over teenage unemployment did play a role in the establishment of a sub-minimum wage in the 1989 Amendments to the Fair Labor Standards Act, which increased the minimum wage to $4.25 per hour in 1991. Rather, we believe that it is the latter part of Stigler's article—questioning the target efficiency of the minimum wage and advocating an alternative remedial policy—that will in the end persuade voters to abandon the minimum wage as a means of helping the working poor.

The Image of a Minimum Wage Worker

Franklin Roosevelt's 1937 impassioned speech calling on Congress to help the one-third of Americans who were "ill-housed, ill-clad, and ill-nourished" heralded in the Fair Labor Standards Act of 1938 and with it a national minimum wage. Echoes of that speech are still heard today. Senator Edward Kennedy (1989: S14707), in his criticism of the most recent increases in the minimum wage, declared:

> The minimum wage was, as it should be, a living wage, for working men and women. . .who are attempting to provide for their families, feed and clothe their children, heat their homes, [and] pay their mortgages. The cost-of-living inflation adjustment since 1981 would put the minimum wage at $4.79 today, instead of the $4.25 it will reach on April 1, 1991. That is a measure of how far we have failed the test of fairness to the working poor.

This New Deal image of low-wage workers struggling to earn a living wage for their families is as poignant today as it was in the 1930s. But Stigler claimed such an image overlooked the slippage between raising the hourly wage of low paid workers and lifting families out of poverty. He wrote, "Unless the minimum wage varies with the amount of employment, number of earners, non-wage income, family size, and many other factors, it will be an inept device for combatting poverty even for those who succeed in retaining employment" (1946: 363). Unfortunately, Stigler had no national data with which to confirm his doubts on this score.

Here we provide an empirical confirmation of Stigler's original position and see how well his views have withstood the test of time. We look at the bottom half of the United States wage distribution and see how well workers' positions in this distribution match the economic well-being of their families.

Data

Our data come from the 1 percent samples of the 1940 and 1950 census, the 1/1,000 samples of the 1960, 1970, and 1980 censuses,

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and the March 1988 *Current Population Survey* (CPS). Our measure of average hourly earnings in the year preceding each census or survey was obtained by dividing the respondent's reported wage or salary income that year by the product of estimated usual weekly hours worked that year times estimated weeks worked that year.[2] We limited our study to 17-to-64 year old wage and salary workers who worked at least 14 weeks in the preceding year and at least 15 hours in the census or survey week.

Our measure of family economic well-being is the family's income-to-needs ratio. This is the ratio of total family income to official Bureau of the Census poverty line for a family of its size. Values of the poverty line for different years were adjusted for changes in the consumer price index. Unfortunately, the 1940 Census did not ask respondents how much income they received from sources other than wages or salaries in 1939. Therefore our measure of family well-being for that year is the ratio of the family's wage or salary *earnings* to its poverty level.

The Link between Wages and Family Income

Table 1 summarizes our findings. Here we present a matrix of coefficients of determination R^2 between the hourly earnings of workers in the bottom half of the wage distribution and the income-to-needs ratio of the households in which they reside.[3] These lower paid workers are classified by family status. In 1939, about one-fifth of the interpersonal variance in the household wage and salary incomes of all these workers was associated with differences in their wage rates, i.e., the R^2 is .207. Not surprisingly, this association was much stronger that year for unrelated individuals (.677) than for heads of families (.241), and was weakest for other family members (.204)—a pattern repeated each year. The much weaker association for workers in families reflects the importance of interfamily differences in number of earners and family size, as Stigler foresaw. Whereas the case for the minimum wage has always rested on the need to help families with low-wage heads, by far the strongest link between low wages and poverty is found among the small minority of workers who live alone.

Whether or not one considers an overall R^2 of .207 as evidence that, in Stigler's words, "the connection between hourly wages and

[2]A detailed summary of estimation procedures and data problems is presented in an Appendix, which will be sent to interested readers upon request.

[3]The median wage provides an upper bound on the range of workers who could conceivably directly benefit from a minimum wage.

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TABLE 1

VALUES OF R^2 BETWEEN HOURLY WAGES AND FAMILY INCOME-TO-NEEDS RATIOS FOR WORKERS EARNING LESS THAN THE MEDIAN WAGE: 1939–87[a]

Year	Median Wage	Values of R^2 for: All Workers	Heads of Families	Other Family Members	Unrelated Individuals
1939[b]	$0.48	.207	.241	.204	.667
1949[c]	1.45	NA	.188	NA	.573
1959	2.05	.130	.174	.191	.547
1969	3.12	.078	.144	.106	.534
1979	5.84	.046	.114	.062	.552
1987	8.65	.050	.137	.056	.382

[a]Workers in the bottom 1 percent of the wage distribution were dropped each year. All correlation coefficients are positive and significant at the .99 level.

[b]Income-to-needs ratios in 1939 exclude income from sources other than wages and salaries (see text).

[c]Owing to unusual sampling procedures in the 1950 Census, data for all workers and other family members are not available for 1949.

SOURCE: 1 percent samples of the 1940 and 1950 census; 1/1,000 sample of the 1960, 1970, and 1980 census; March 1988 *Current Population Survey*.

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the standard of living of a family is remote and fuzzy" (1946: 363) is debatable. But time has been on Stigler's side. Since 1939 the connection between below median wages and family income has weakened dramatically. By 1979, the coefficient of determination had fallen to .046 for all workers, .114 for family heads, and .062 for other family members. Much of the downtrend is due to the spread of multiple earner families. Only for unrelated individuals does the tie between lower pay and lesser well-being remain strong. Data from the March 1988 CPS tell a very similar story.[4]

An Old Public Policy Lesson for a New Day

In the 1930s, social reformers advocated a minimum wage to ensure that the families of those who worked would receive a living wage.[5] In the absence of a federal safety net to provide income more directly to those judged to be in extreme poverty, it could be argued that this indirect method of targeting the poor may have been acceptable policy. Today, like-minded reformers are disappointed with the current federal safety net. The accumulation of large budget deficits and a public opposed to higher taxes have made such reformers look once again to private-sector mandates as a means of ameliorating poverty.

Table 1 should, we think, give pause to those who still hold a 1930s' view of poverty relief. Save for unrelated individuals, the link between how much a worker earns per hour and the economic well-being of his or her household is now almost completely lost —and, along with it, the target efficiency of minimum wage legislation. But the severing of this link has implications beyond minimum wage policy. In order to insure tax exemption status for their fringe benefit packages, firms are required to provide them "equitably" across the wage distribution of their employees. Our table suggests that in a world of multiworker families, such regulations may provide far less income to low income households than meets the eye. This same point can be raised with respect to attempts to mandate mandatory

[4]For evidence that the economic well-being of the families of minimum wage workers improved greatly from 1949 to 1979 and a simulation of how the benefits from the most recent increase in the minimum wage were distributed, see Burkhauser and Finegan (1989).

[5]Thies (1991) traces the history of minimum wage policy back to the period of individual state-initiated minimum wage legislation in the early twentieth century and argues that Father John A. Ryan's book *A Living Wage* (1909), popularized the view that "employers were normally obligated to pay workers a living wage, and [Ryan] advocated state coercion of the same through laws providing for minimum wages. . ." (Thies 1991: 720).

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minimum health or pensions for all workers. Supporters of such mandates almost always assume that low-wage workers live in low income households.

The Earned Income Tax Credit

A superior alternative to these employer-mandated strategies of redistributing income to the poor is the Earned Income Tax Credit (EITC). In 1992, this program provided a tax credit of 17.6 cents per dollar of the first $7,520 of wage earning in a poor family with one child and 18.4 cents per dollar on the same amount for a family with more than one child. Benefits are phased out at a rate of 12.57 (13.14) cents per dollar above $11,840 for a one (two or more) child family and all benefits are lost at an income level of $22,370. This grandchild of the negative income tax advocated by Stigler in 1946 is far more target efficient than a minimum wage.[6] In addition, unlike the minimum wage which reduces the demand for low skill labor, the EITC has no adverse affects on the demand for such workers.[7] In 1993 the Clinton Administration, with bi-partisan Congressional support, greatly expanded the Earned Income Tax Credit so that by 1996 it will provide a tax credit of 34 cents per dollar on the first $7,520 of wage earning in a poor family with one child and 36 cents per dollar for such a family with more than one child. But in the same year the Clinton Administration also called for a $0.25 increase in the minimum wage.

[6]The target efficiency of a negative income tax has long been recognized by economists. Christopher Green (1967) believes the two main proponents of this form of distribution to the poor in the 1960s were Milton Friedman [see Friedman (1962)], and Robert J. Lampman [see Lampman (1965)], but that its origins go back to the 1940s. According to Green, "correspondence with Friedman, Walter Heller, William Vickrey, and Louis Shere turned up the fact that there had been some discussion of [a negative income tax] during the 1940s, and that the subject had been informally discussed by some researchers, including Heller and Vickrey, then at the Division of Tax Research, Treasury Department. There is no evidence, however, that a paper on the subject was prepared in the Division of Tax Research" (Green 1967: 57, n. 21). He then cites the Stigler (1946) article as evidence that the idea was in the air in the 1940s. Stigler, in personal correspondence with the authors, reported that "for some reason that I cannot recall but have long regretted, I omitted from my passing endorsement of the negative income tax the appropriate footnote, 'I'm indebted to Milton Friedman for this suggestion.' "

[7]Burkhauser (1992) and Burkhauser (1993) advocate extension of the Earned Income Tax Credit as the least disruptive means of increasing the income and employment of workers with disabilities who live in poor families. The EITC is argued to be a far superior mechanism than the Americans with Disabilities Act of 1990 of assisting the "doubly disabled"—those who have both poor work skills and health impairments.

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Here we have provided some evidence to support Stigler's view that the connection between wages and family income was remote and fuzzy even in 1946. We provide stronger evidence that the views of Nobel Prize winners tend to be ahead of their time.

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Checking Out the House

Jim F. Couch and William H. Wells

The Traditional Explanation for Excessive Government

Citizens interested in responsible federal spending have been sorely disappointed with recent results. An explosion of federal expenditures has occurred in this century. As reported in the *Economic Report of the President* (1993), total federal government expenditures in 1992 as a percentage of GDP was 23.5 while only 10.8 percent of GDP in 1934.

Economists offer several explanations for the growth of government spending. Spending can stimulate the economy in the short run by increasing output and lowering unemployment. Politicians that hope to be reelected are encouraged to take a short-run view since it is in their interest to see that the economy performs well today (Nordhaus 1975). Stimulative fiscal policy can help ensure that outcome. Spending is also attractive to members of Congress because they are elected from a particular geographic region rather than at large. These elected representatives receive a higher political payoff from promoting the local interests of their constituents than they do from taking positions in support of the so-called public interest. Therefore legislators have a strong incentive to search for public policies and programs that confer direct benefits on their home districts while imposing costs on taxpayers in general, most of whom reside, and vote, in other jurisdictions. Incumbent politicians are able to use such techniques to enhance their prospects for reelection. The fact that challengers rarely win congressional elections along with the idea that "career politicians" are largely responsible for the

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burgeoning deficit has stimulated the call for term limits, although the actual effects of term limits are unknown.

Pressure groups, in the form of Political Action Committees (PACs), have also been blamed for the explosion in government spending. These organizations supply votes and campaign contributions in exchange for favorable legislation that increases the net wealth of the special interest group. Several studies can be found in the literature supporting this notion. Gary Becker (1983, 1985) developed a model relating the influence of interest groups to the growth of government. Dennis Mueller and Peter Murrell (1986) present empirical evidence linking the number of pressure groups in a country to the relative size of the government sector. Robert McCormick and Robert Tollison (1981) find the amount of regulatory expenditures across states to be related to the number of trade associations operating within the state. Thus, the drive to enhance the prospects of reelection serves as a major component of the traditional explanation for excessive government spending.

An Alternative View

The parochial interests of politicians elected from specific regions, the influence of special interest groups, and the myopic outlook of our elected officials are all valid explanations for increased government spending, but our research suggests something far more fundamental. In this paper, we seek to develop an explanation that links some of the characteristics of politicians to their more liberal spending practices within their public roles. As our dependent variable, we use the voting record of the House of Representatives of the 100th Congress. Explanatory variables include: (1) the percentage of campaign contributions coming from PACs, (2) the number of years served in the House, (3) the number of bad checks as revealed in the House banking scandal and (4) the percentage of votes received in the last election.

Model

The National Taxpayers' Union (NTU) *Congressional Spending Study* (1988) provides the voting record of every member of Congress.[1] The NTU study analyzed every roll call vote taken during the second session of the 100th Congress (1988) that affected the

[1]The NTU weights congressional votes according to the degree that each vote affects federal spending. The score can range from zero (a high spending tendency) to 100 (a low spending tendency). A score of zero would indicate that a congressman voted in favor of every spending proposal.

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amount of federal spending. From this information, a spending score was determined with higher scores representing more frugal voting records. Scores ranged from a high of 75 percent recorded by Philip Crane (R-Ill.) to a low of 5 percent recorded by Jerry Costello (D-Ill.) Variables used in the study to explain the tendency to spend, as measured by these scores, include: (1) the number of years that the individual served in the House (YEARS in Table 1), (2) the percentage of their campaign contributions that are supplied by political action committees (%PAC in Table 1), (3) the percentage of votes they received in their last election (%VOTE in Table 1), and (4) the number of bad checks they wrote (BOUNCE in Table 1).[2]

If our results agree with previous studies regarding pressure groups and the growth of government, a negative relationship between %PAC and the NTU voting record is predicted. The predicted sign of %VOTE is positive since those politicians winning by a greater margin should be more inclined toward spending. The correlation between BOUNCE and the voting record will reveal whether there is any relationship between what politicians do in their personal affairs and how they conduct themselves as public servants. Specifically, the empirical results should provide evidence as to whether financial irresponsibility regarding personal matters translates into fiscal irresponsibility regarding the public's funds. The final variable, YEARS, should provide some evidence regarding the efficacy of term limits. It is impossible to accurately predict how term limits will affect the operation of Congress. Hence we have no prediction regarding the sign of the variable YEARS.[3]

Results

Empirical results are given in Table 1. Ordinary least squares was used to estimate the equation. The R^2 was approximately 14 percent. Obviously a myriad of factors influence the voting record of members

[2]Previously, data regarding the personal matters of politicians was limited at best, but the House banking scandal of 1992 has changed that situation. The House Ethics Committee released the names of 303 current and former members who overdrew their accounts at the now-closed House Bank. Apparently, many of our elected officials who have been given the task of balancing the federal budget found the challenge of balancing their personal checking accounts beyond the scope of their abilities.

[3]By way of illustration let us give two statements here pertaining to the question of term limits. Ronald Elving (1990: 3145) quotes Gary Becker as writing, "it seems clear that reducing an incumbent's advantage will not significantly improve how Congress works, and it could well make matters worse." On the other hand, Edward Crane of the Cato Institute is quoted by Elving (1991: 3102) as saying, "I'm told term limits would cost us our most experienced legislators—all I can say is I hope so."

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TABLE 1

NATIONAL TAXPAYER UNION VOTING SCORE REGRESSION

Independent Variable	Estimated Coefficient (Absolute Value of the *t*-Statistic)
CONSTANT	93.024* (12.45)
BOUNCE	−0.023* (2.62)
%PAC	−0.422* (5.55)
%VOTE	−0.216** (2.27)
YEARS	−0.573* (3.65)
Adjusted R^2	0.139
F	17.144

*Significant at the 1% level.
**Significant at the 5% level.

of Congress. If omitted variables are correlated with variables included in the model, our results would be weakened.

The dependent variable in the analysis was the NTU spending score of the House of Representatives of the 100th Congress. A significant negative relationship exists between this spending score and the number of bad checks. For every increase in the number of bounced checks, the score falls by 0.023 points—indicating that politicians who cannot balance their own checking accounts find it difficult to resist the temptation to spend government funds in excess of government revenues. Hence, profligate representatives do not discriminate between private and public funds in this regard—they spend both equally well.

Also contributing to spending is the percentage of contributions coming from PACs. The relationship between special interest groups and politicians can be viewed as that of a principal and agent. The special interest group (principal) elects (hires) the politician (agent) in order to receive preferential consideration in the form of subsidies and, or, favorable legislation. Not surprisingly therefore, the pressure to spend increases, as the makeup of the campaign-"war chest" becomes more and more dominated by special interest money. A 1 percent increase in PAC contributions is associated with a 0.42 drop in the congressional spending score.

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Conservatives' call for term limitations also seems to be reasonable when looking at our results. For every extra year of service in the House, spending scores fall by 0.57. Thus, we present empirical evidence that term limits could be an effective means of reducing excessive spending. The coefficient of %VOTES is negative and significant indicating that those candidates receiving a larger margin of victory are inclined toward more liberal spending. This comfort zone gives the politician more discretion in spending the taxpayer's money. Those with a more narrow margin of victory are perhaps more timid and certainly less reliable in the vote trading process that characterizes Congress.

Conclusion

Our results seem to indicate that calls for campaign finance reform and term limits are steps in the right direction if we are serious about balancing the federal budget. Our analysis also provides empirical evidence that the administration of personal finances of House members provides a good indicator of their spending habits in public life. While other factors certainly impact a politician's spending practice, the model, in its present form, may be used to provide an indication of a House member's proclivity toward government spending.

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The Politicization of Monetary Policy: The Vice Chairman as the Administration's Point Man

Thomas Havrilesky

The Trend in Politicization

Traditionally, the Federal Reserve Chairman has been considered the most important figure in the monetary policy arena. Evidence regarding whether the Chairman systematically resists administration and congressional pressures or succumbs to them is a matter of moment for scholars and financial market participants alike (Havrilesky 1993). In light of the persistent political pressures, since the 1960s, and the trend, since 1935, of deterioration of traditional constraints on the political manipulation of monetary policy,[1] such evidence is of considerable concern to those who would reform our institutions in order to contain latent inflationary excesses. As the erosion of monetary discipline in the 1935–75 period was a prelude to the double digit inflation of the 1970s and early 1980s, continued breakdown in the current decade is a likely precursor of adverse future consequences.

One of the remaining traditional constraints on monetary excesses is the presence of non-politically appointed members on the Federal Open Market Committee (FOMC). Numerous studies show that nations with less political, more autonomous, central banks have

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[1]Constraints on the political manipulation of monetary policy that have been weakened or destroyed since 1935 include the gold reserve requirement on currency, the gold reserve requirement on bank reserves, the decentralization of power within the Federal Reserve and private sector representation within the Federal Reserve. For further detail see Havrilesky (1991). Time series measures of the external pressures on monetary policy are presented in Havrilesky (1993).

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superior inflation performance. If Congresspersons Paul Sarbanes (D-Md.), Byron Dorgan (D-Mass.), David Hamilton (D-Ind.), and Henry Gonzalez (D-Tx.) have their way with individual legislation that they are each currently sponsoring, all voting members of the Federal Open Market Committee will be politically appointed and the politicization of monetary policy will take a quantum leap forward.

In some cases the politicization of monetary policy proceeds in a more subtle manner. It does not feature acts of Congress. It is not even marked by legislative discussion, overt executive branch initiatives, or discernible external pressure on the Federal Reserve. This paper considers one such instance.

The Role of the Vice Chairman

Virtually unnoticed in the drift toward politicization during the past six decades is a change in the role of the vice chairman of the Board of Governors of the Federal Reserve System. Since 1951 there have been eight vice chairmen: C. Canby Balderston, James L. Robertson, George Mitchell, Stephen Gardner, Frederick Schultz, Preston Martin, Manuel Johnson, and David Mullins. Of these eight, the first three were chosen from within the Federal Reserve System; they were awarded the post because of seniority within and service to the System. C. Canby Balderston had been a director of the Federal Reserve Bank of Philadelphia. He served as William McChesney Martin's first Vice Chairman and was reappointed under Dwight Eisenhower and John Kennedy. When his term expired in 1966 he was replaced by J.L. Robertson who had initially been appointed to the Board by Harry Truman. In 1973, George Mitchell, a Kennedy Board appointee, was given the number two position on the Board because he, like Robertson before him, was its most senior member at the time.

The role of the vice chairmanship changed forever in 1976. In that year the Ford administration selected Stephen Gardner to be the number two person at the central bank. Gardner had no Fed experience but rather was identified with the administration where he had served as deputy secretary of the Treasury and was instrumental in promoting administration-supported banking legislation. The governor with the greatest seniority at the time was Henry Wallich, an academic economist with firm conservative views on monetary policy. The departure from tradition did not go unnoticed. Gardner's nomination was resisted in his confirmation hearings by senators who believed the Board to be packed with administration loyalists,

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each sponsored by Chairman Arthur Burns (Schellhardt, *Wall Street Journal*, 15 December 1975). The choice of Gardner rather than Wallich likely reflected Burns' imprint rather than that of Gerald Ford, who, like Dwight Eisenhower, affirmed a hands off attitude toward monetary policy (Havrilesky 1993).

Consonant with other aspects of the advance of politicization in the 1970s, such as systematic Federal Reserve compliance with executive branch desires for monetary policy (Havrilesky 1993), the 1976 change created a precedent. Jimmy Carter's appointment of Frederick Schultz sustained the practice of selecting an administration, rather than a Federal Reserve, loyalist as vice chairman. Before Carter appointed Schultz in 1979 he had been the President's choice for Undersecretary of Health, Education and Welfare until Secretary Califano opted to pick his own staff. Schultz was a Florida legislator who had run unsucessfully for Senate in 1972; in addition, he was a major contributor to Carter's campaign (*New York Times*, 13 April 1979; 16 April 1979). As with Gardner's confirmation process, there was resistance because Senate Banking Committee Chairman William Proximire (D-Wis.) believed the nominee's ties to the administration were too strong.

The politicization of the vice chairmanship peaked in stridency with Ronald Reagan's choice of Preston Martin in March 1982. In 1967 Governor Reagan had selected Martin as California's Savings and Loan Commissioner and in the early 1970s Martin was picked by Richard Nixon to be Chairman of the Federal Home Loan Bank Board. As Vice Chairman, Martin came to play the role of spokesperson for supply side devotees within the Reagan camp who favored easy monetary policy. For example, Jude Wanniski referred to him as "our great hope" who "will save us from the madmen . . . who want to shut down our economy" and Jack Kemp said that he would make a "very good" chairman (McGinley, *Wall Street Journal*, 8 May 1984). In December 1983, fired by ambitions for the chairmanship that were doubtlessly fueled by supply side cadres, Martin became openly critical of the Fed's non-expansionary monetary policy. He blatantly broke the Fed's rules by sending minutes of the latest Federal Open Market Committee meeting to the press accompanied by a note explaining his dissent on the side of monetary stimulation (McGinley, *Wall Street Journal*, 8 May 1984). Undaunted by the ensuing scorn of his colleagues, the Vice Chairman continued to dissent and use the media to promote monetary ease (Murray, *Wall Street Journal*, 27 August 1984). For a vice chairman to go public in this manner was interpreted in central banking circles as an affront to the institution wherein even dissent voting on monetary policy

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directives by vice chairmen is a rarity. For example, in 86 split decision FOMC votes on monetary policy from 1976 to 1991, only six dissents were cast by vice chairmen and Martin was responsible for five of these.

The climax to Martin's crusade for stimulatory monetary policy occurred in February 1986 when he led the phalanx of three other, recently appointed, supply side proponents on the Board, Wayne Angell, Martha Seger, and Manuel Johnson, in outvoting Chairman Paul Volcker in favor of a discount rate cut. The financial services sector scored his disturbing behaviors and his internecine challenges to Volcker. After new Board members Angell and Johnson compromised with Volcker to delay the rate cut in order to avoid his resignation, Martin's assault on sound money came to an abrupt halt. He resigned from his post in April 1986, one month after his term as vice chairman expired (Bluestein, *Wall Street Journal,* 20 March 1986; 24 March 1984).

Unwilling to depoliticize the vice chairmanship but instructed by the tumult of Martin's tenure, the Reagan administration was more careful in its next, May 1986, appointment. Consistent with his pivotal role in delaying the February-March 1986 discount cut rate and thereby preventing Volcker's resignation, as vice chairman former Assistant Treasury Secretary for Economic Policy Manuel Johnson was able to advance the supply side penchant for monetary expansionism without offending the Chairman and arousing ire in private financial circles. Johnson enunciated his credo, "you can get things done without pushing your way around" (Bluestein, *Wall Street Journal,* 14 May 1986). Nevertheless, some administration hardliners were not always pleased with his inoffensive demeanor. Budget Director Richard Darman referred to Johnson as "right in terms of economics, but too nice a guy" (Wessel, *Wall Street Journal,* 6 October 1992).

With the next appointment to the vice chairmanship the Bush administration resolved the nice guy-versus-hardliner tradeoff on the side of the latter. Before David Mullins was selected in late 1989, he had served as Assistant Treasury Secretary, as a top staffer on the Brady Commission (on financial reform) and as principal author of Bush's Savings & Loan bailout program. After he informed Brady that he wanted a Board position, the Treasury Secretary blocked the appointment of Stanford Economics Professor John Taylor and instead successfully sponsored Mullins. Mullins' style in confrontations with Alan Greenspan to advance administration desires for easy money was described as "constantly pounding" against Greenspan (Wessel, *Wall Street Journal,* 6 October 1992). In the arena of give-

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and-take permitted by Greenspan, Mullin's steely determination combined with understanding of and acumen with financial data was invaluable in helping him make successful cases for monetary ease. In the words of a Fed staffer, "He hit it hard and did a good job" (McNamee, *Business Week*, 16 December 1991; 30 March 1992).

Conclusion

Across three-score years our monetary policy institutions have become increasingly politicized. The current promotion of legislation which would remove all non-political appointees from the Federal Open Market Committee suggests that, until the dire implications are recognized, this trend will continue in the foreseeable future. Examination of the workings of the FOMC in the past forty years reveals evidence of the politicization of monetary policy that does not always entail bold legislative or executive branch actions. A case in point here is that after 1975 the vice chairman of the Federal Reserve Board assumed the mantle of advocate of administration desires for monetary policy. Monetary policy scholars and students of monetary reform should be aware of how far the deterioration of our institutional defenses against inflationary excesses has progressed.

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BOOK REVIEWS

Welfare Economics and Externalities in an Open-Ended Universe: A Modern Austrian Perspective

Roy E. Cordato

Dordrecht, Netherlands: Kluwer Academic Publishers, 1992, 140 pp.

Roy Cordato has written a provocative and valuable book. He has dealt exhaustively, competently, and patiently with important and subtle issues. His treatment is, at key points, thoroughly original, and he has consistently tackled difficult conceptual themes with rare depth of insight. As a scholarly contribution to modern Austrian economics, Cordato's book is a solid performance, demonstrating impressive mastery of both the Austrian and neoclassical literatures. It is very much to be hoped that this fine work will spark additional research into the difficult, but crucially important areas of economic and social theory on the part of the new generation of Austrian economists.

This reviewer finds himself extremely impressed by this work and particularly by Cordato's devastating critique of standard welfare economics and (with relatively minor reservations) by the statement of his own carefully crafted concept of catallactic efficiency. Yet it must be confessed that this reviewer leaves the book not without a certain sense of unease. The overall message of the book, for all its courageous debunking of orthodox sacred cows, for all its sensitive extensions of Austrian insights, yet raises certain troubling questions. The quality and integrity of this work demands that these questions be honestly raised. The following pages briefly set forth the core of Cordato's own contribution, spell out the problems with which this reviewer finds himself confronted in Cordato's presentation of his thesis, and suggest (with some confession of elements of vested interest on the part of this reviewer) how what is most important and original in Cordato's valuable thesis can perhaps better be preserved within a restated "coordination" approach to welfare economics—an approach which Cordato considered but felt compelled to set aside.

Cordato's signal contribution consists in his superb articulation of the Austrian critique of mainstream welfare economics and of his deploy-

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ment of that critique to develop his own concept of catallactic efficiency. (Cordato devotes much effort to exploring the welfare implications of externalities, by diligently and consistently applying his criterion of catallactic efficiency. It is, however, in this part of his work that those problems arise to which we shall turn in the next section.)

As is made clear in the book's title, we live in an open-ended universe of continuous trial and error, of continuous disequilibrium generated by continual changes in the underlying data, reflected in continual changes in the knowledge and expectations of market participants. In this open-ended world, individuals pursue their own objectives in the light of what they believe to be the opportunities made available by other individuals pursuing *their* objectives. To judge the efficiency of such a system *as a whole* in the same way an individual may judge the efficiency of his own plans for action—as standard welfare economics seeks to judge the efficiency of the system—is to do violence to the reality of the market. An individual judges the extent to which his means-allocation pattern is geared towards the efficient achievement of his objectives (in terms of his own ranking of the relative importance of these conflicting objectives). A society never does face such a problem: (a) there is no single social "mind" that ranks the relative "social" importance of the objectives independently pursued by the individual members of society; (b) with information unavoidably dispersed among the members of society, there is no single mind to which all the relevant resources and all the relevant objectives are simultaneously given. The device employed by mainstream welfare economics—i.e., the setting up of the model of perfectly competitive equilibrium as the perfect standard of efficiency, against which all real world situations can in principle be compared—is wholly irrelevant to the conditions of real world open-endedness and thus offers no valid basis for reaching welfare judgments. "By abstracting from the passage of time and by focussing on a perfectly competitive end-state, the orthodox welfare standard judges market phenomena using a model of the world in which many of the most important elements of real market are defined out of existence" (p. 5).

A particularly interesting feature of Cordato's criticism is that it clearly identifies in the Coasean approach to social-efficiency questions exactly those central features that render mainstream welfare economics unacceptable. Despite the validity of Coase's own criticism of Pigouvian welfare economics in regard to the treatment of externalities, the truth remains, as Cordato cogently makes clear, that Coase believes it possible to treat the social benefits and costs (generated in the course of behavior that results in external effects) as if they are objectively comparable (see also R. Cordato 1992; and G. North 1992: chap. 3 and 5).

Instead of this mainstream perspective on social efficiency, Cordato develops his own concept of catallactic efficiency, building on the writings of Friedrich v. Hayek and other Austrians who have perceived the market economy as a catallaxy and emphasizing the Austrian tenet of

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subjectivism and methodological individualism. "A catallaxy is a social order generated by the market activities of separate individuals and organizations, each pursuing their own purposes" (p. 58). Efficiency theory cannot, in dealing with a catallaxy, make reference to any social hierarchy of values. Nor, most importantly, can it "make assumptions concerning the amount of knowledge that is 'given' to market participants" (p. 60). Catallactic efficiency is to be judged "by the extent to which the catallaxy encourages individuals existing in a social context, to pursue their own goals as consistently as possible" (p. 62). Such encouragement must proceed by providing the institutional setting, (a) "that will allow individuals to gather the necessary physical resources" for the achievement of their goals, and (b) that "will best facilitate the use and discovery of information" (p. 63).

In Cordato's discussion it turns out that the institution of private property with freedom of competitive entry provides the ideal setting "within which individuals, as social beings, are able to most efficiently pursue their goals" (p. 65). Within this setting, "mutually agreed upon market prices will reflect as much information about market participants' preferences, expectations, and perceptions of resource scarcities as possible" (p. 67). Catallactic inefficiency occurs when market prices have captured "erroneous" information about supply and demand conditions, resulting from "false perceptions of individual traders" (p. 68). The incentive to make entrepreneurial profit and to avoid losses tends to bring about corrective revisions of these false perceptions. "Because of the open-ended nature of catallaxy, though, this is a continuously unfolding process where new, false information is always being filtered out" (p. 68). Catallactic inefficiency may, however, also occur as a result of institutional flaws in the security of private property rights. It is only the latter type of inefficiency that may be relevant to policy—for example, in regard to the treatment of certain externalities.

Cordato pursues these valuable ideas with careful consistency in seeking to apply them critically to the manner in which externalities provide mainstream welfare economics with justification for interventionist policies supposedly designed to enhance social welfare. It is here that some disturbing questions arise, to which we now turn.

It is clear that Cordato's criterion for catallactic efficiency is concerned with a totally different dimension of social well-being than that dealt with in standard welfare theory. Standard theory is concerned with enhancing some variant, or proxy for "aggregate utility." Cordato's criterion, denying any scientific meaning to concepts such as aggregate utility (or any of its proxies), confines itself to the question of enhancing the environment within which individual goal-seeking behavior can be facilitated in society (especially by facilitating the discovery of relevant information upon which mutually beneficial exchanges can be based). As Cordato seems to recognize at several places, the questions dealt with in standard welfare economics are in fact questions that must be dealt with *as ethics*, rather

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than as questions of economic science. "Every time an economist views policy analysis in terms of social costs and benefits, the ends of different actors are being compared to determine their relative 'value' to society. From the perspective taken in this book," Cordato comments, "this is inherently an ethical question, the answer to which cannot be grounded in economics" (p. 113). That observation is entirely appropriate.

But to identify certain question as being beyond the scope of the tools of economic science is, of course, not at all the same as to assert that economic science has demonstrated that these questions are not worth asking. To show that the criterion of catallactic efficiency fails to identify any *catallactic inefficiency* in a particular market phenomenon (let us say, a good not having been produced as a result of free-rider complications) is of course not to declare that economic science has demonstrated the *ethical desirability* of that phenomenon. The methodological individualism that, for Austrians, is the beginning of economic science—and thus of Cordato's carefully devised criterion for catallactic efficiency—does not and cannot declare it illegitimate, *as a matter of ethics,* to treat society as a single, integrated entity attaining some level of aggregate well-being (somehow conceived, ethically, in supra-individual terms). Economic science is neutral with respect to such ethical questions. There is nothing in Cordato's valuable notion of catallactic efficiency that is necessarily inconsistent with these obvious observations. Yet, at certain stages in his arguments, Cordato seems to come perilously close, in effect, to denying them.

In all candor, it must be conceded that this complaint against Cordato is not easy to document. Although Cordato freely and frequently declares situations, pronounced as inefficient by standard welfare economics (and therefore as calling for corrective intervention), as in fact being fully efficient and therefore justifying no such intervention, this can (and presumably should) be interpreted as meaning that *from the point of view of the catallactic criterion,* no intervention is called for. But the overall thrust of his exposition leaves one decidedly uncomfortable. Cordato does seem to believe that where a free-market outcome cannot be pronounced as traceable to catallactic inefficiency, this at once categorically establishes the economic error of any interventionist policy in regard to that situation.

In dealing with the free-rider explanation of why a good might go unproduced in a market, for example, Cordato insists that this "has no normative implications. A production level of zero is no less optimal than any positive level of production. In fact, so long as that outcome reflects a market process that was the result of decisions made within the context of the [ideal institutional setting], the process *and therefore the outcome* would have to be judged efficient" (p. 83, emphasis added). Here Cordato has perhaps transgressed the spirit, at least, of his catallactic efficiency criterion. Surely his criterion refers strictly to the environment within which the market *process* unfolds, rather than with any

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efficiency or inefficiency of market *outcomes*. If citizens are convinced (on ethical, not scientific grounds) that an outcome in which some pure public good goes unproduced would be unanimously pronounced suboptimal (as compared with some hypothetical state in which that good were somehow being produced, say, through state subsidy), Cordato cannot pronounce them to be *wrong;* he can merely say that the catallactic efficiency criterion gives the economic scientist qua scientist no license to comment on the situation. It may be true that the economic scientist may point out that the transactions costs required, within a market, to organize defenses against the free-rider problem (and thus to permit market production of the good) may be too formidable to justify spontaneous market production of the good. The market environment has indeed not "failed"—but neither has it succeeded (under the circumstances here postulated) in arranging the flow of resources along channels unanimously held (on *ethical* grounds, remember) to be the most desirable ones for society as a whole.

There is an irony here, which Cordato at one stage (p. 84) seems himself to have sensed. After all, the very institutional setting required for catallactic efficiency, viz., the securing of the rights of private property and freedom of competitive entry, could hardly have emerged without somehow overcoming (usually in fact by the use of state coercive power) obvious public goods problems. Cordato properly argues that we can discuss the efficiency of catallactic processes only on the assumption that the right to trade somehow already exists. But once we recognize that extra-(catallactic)-efficiency considerations may have to be invoked to justify the institutions that permit catallactic efficiency to flourish, it becomes difficult abruptly to ignore the possibility of extra-(catallactic)-efficiency considerations that may, under specific circumstances, justify suspension of or interference with market processes.

Our point is not, of course, to argue for such interventions. It is easy, having doffed one's scientist's hat, to supply possible *ethical* grounds for resisting such interventions. We wish only to point out that Austrian welfare economics must necessarily—for all the good reasons so well articulated by Cordato—be confined to a rather narrow band of questions. The fact that these questions are important ones, and the fact that Austrian arguments refute standard welfare theory based over-ambitiously and uncritically on imprecise conceptual foundation, renders Cordato's catallactic efficiency criterion a valuable and significant tool. It would be a great pity if the value of Cordato's work comes to be dismissed as result of a possible (and entirely unnecessary) impression that exaggerated claims are being made on behalf of the criterion.

It is with some diffidence that I suggest (as a result of the concerns just expressed) the following modification of the way in which Cordato's catallactic efficiency criterion is presented. I believe that the criterion will gain in understandability and will carry more conviction if presented explicitly in terms of the *coordination* of individual decisions in respect

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of exchange. What is meant by coordination, in this context, refers, it must be emphasized, strictly to the *process* through which individuals, between whom exist the potential for mutually gainful exchange, *come to be made aware of this mutually gainful possibility*. Once it is made clear that "efficiency" is being discussed solely in terms of the promotion of gainful trade, there is little danger that demonstrated absence of "inefficiency," will be interpreted as implying a claim that we live in the best of all possible worlds.

Cordato does consider such a coordination formulation, but rejects it on a variety of grounds. The principal objection (see p. 52) appears to be the following. Let us imagine two separate markets for the same good, each in complete equilibrium. With different prices for the same good in these two markets, an entrepreneur now discovers the profit possibility and moves to exploit it by buying in the one market and selling in the other. Surely this discovery and profit-making move are consistent with catallactic efficiency—yet it appears to involve the discoordination of plans for exchange that had been made earlier within each of the separate markets. Apparently a catallactically efficient event may be discoordinating. I believe this reasoning to be incorrect—or, rather, to be based on an apparent misunderstanding of the relevant coordination concept.

It is quite true that an entrepreneurial discovery may disrupt plans that had been made for exchange. A buyer who had confidently expected to buy the good (let us imagine it to be a resource) in the low-price market, now finds that the sellers are selling to the new entrepreneur at a higher price. It may certainly be said that the entrepreneur has disappointed those potential resource buyers. And, as Cordato points out, such disappointment may extend to those who might have bought the goods (from the aforementioned potential resource-buyers) that might have been produced by using the low-priced resource (that has now become a higher priced resource, used only for other goods). What must be emphasized, however, is that such disruptions of plans and such disappointments have not discoordinated exchange plans, in the relevant sense, one iota. The new entrepreneur by bringing together sellers (in the low-price market) with buyers (in the high-price market) has coordinated these buyers and sellers (by making them aware of the possibilities for mutually gainful exchanges—these possibilities having already existed unbeknownst to the potential beneficiaries).

Those buyers in the low-price market, disappointed in their hopes of buying the resource cheaply, have not been "discoordinated" (although, to be sure, they have been disappointed and their plans have been disrupted). This is because discoordination does not, in the present sense of the term, refer to the disappointment of *plans*; it refers to the frustration of potentially gainful exchange between possible participants. What has happened in the presently considered case is that the entrepreneur who engages in arbitrage between the two markets has revealed *that no possibility for mutually gainful exchange exists any longer at*

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the old low price. This indeed disappoints those who made their plans in error but it has not frustrated any present possibilities for mutually profitably exchange. Catallactic efficiency may well bring disappointment to those who have made entrepreneurial errors; but it never, insofar as it promotes entrepreneurial discovery, discoordinates (in the important sense here described).

The adjective "catallactic" is used by Cordato to remind us of Hayek's important distinction between "catallaxy" and "economy." By focussing on the coordination involved in catallactically efficient market processes, we can add emphasis to the goal of effectuating all opportunities for mutually gainful *exchange*. Emphasizing this goal will on the one hand draw attention to the genuine power and clarity of Cordato's catallactic efficiency criterion; on the other hand, such emphasis will discourage misinterpretation of the criterion as implying more than it can possibly deliver. This can only enhance the worth of Cordato's valuable contribution to Austrian economics.

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Combating Poverty: Innovative Social Reforms in Chile during the 1980s

Tarsicio Castaneda
San Francisco: ICS Press, 1992, 259 pp.

This book summarizes and analyzes the remarkable reforms of social welfare programs that occurred in Chile during the 1980s. The reforms covered are in the areas of education, health and nutrition, housing, social security, and interrelations between the central and local governments. While there is a considerable emphasis on reforms related to poverty alleviation, two of the areas—social security and intergovernmental relations—have rather little direct relevance to poverty. The social security reform gave some emphasis to the alleviation of poverty, but the social security system is primarily a middle-class issue or perquisite.

The author states (p. 13) that the social reforms were based on five common principles:

> First, the government should target subsidies to the poorest segment of the population rather than attempt to meet the basic needs of the entire population. . . . Second, social services should be

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> provided by municipalities and the private sector, which are closer to the beneficiaries than is the central government. Third, financing for social services should be based on services provided rather than on historically based budget allocations. Fourth, subsidies should be given directly to beneficiaries rather than to providers. . . . Fifth, the public sector should undertake only those activities that are socially profitable and that no private-sector party is willing to provide.

These are principles or guidelines that can be recommended to any government that sincerely wishes to combat poverty or increase the effectiveness of governmental expenditures.

It is not possible in a review to summarize all the reforms and their effects. I shall instead try to discuss the nature of the education reforms, to present some information on the changes in health and nutrition, and, finally, to note the efficiency and distribution effects of the social security reforms.

The major components of the education reforms consisted of decentralizing the provision of public education to the municipalities, providing federal money to both municipal and private schools on the basis of the number of students rather than the historical allocation, and raising tuition at the university level while introducing loans for needy students. An important effect of these reforms was to increase the percentage of public funds spent on preschool and primary education from 38.6 percent of the total in 1974 to 57.4 percent in 1986 and to reduce the allocation to universities from 47.4 percent to 23.8 percent. The percent spent on secondary schools increased from 14.0 to 18.8 percent.

The overall effect of these changes on the distribution of education spending by income group was to increase the percentage spent for the benefit of the poorest 30 percent of the population from 28.6 percent in 1974 to 37.5 percent in 1986. The share going to the richest 40 percent declined from 47.3 percent in 1974 to 34.5 percent in 1986. The quality of primary education improved in terms of reduction of dropout rates and increase in promotion rates.

The reforms did not always work out as expected, however. A brief note on two glitches in university-financing reform may be of interest. The reform provided for per-student payments to be made for both public and private universities. One part of the formula was that payments were to be made for the 20,000 (out of 30,000) students who had the highest scores on the college entrance examination, while the other part was that the payment was differentiated by the field of study according to estimated costs of instruction—payments varied by a factor as much as 2.5 to 1.

The universities responded to these incentives. The older and more prestigious universities attracted the majority of the students with the highest scores and probably competed vigorously for them; consequently, a large share of this transfer went to the established institutions.

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The differentiation of payment by field of study resulted in universities expanding enrollments in the fields that brought in the most money; some universities apparently opened up new fields of study or, perhaps, renamed some old ones. These two aspects of the reforms had to be dropped. The universities were paid for all students and the payment was the same for each field. You just cannot trust university administrators, or any other welfare recipient, not to take advantage of incentives that are offered.

In the health area, primarily through targeting expenditures and services, remarkable reductions in infant mortality were achieved between 1974 and 1986. Real expenditures for health care increased by about 50 percent between 1974 and 1982, but because of the budget difficulties in 1982, expenditures declined significantly. By 1986, real expenditures were only 20 percent above those of 1974. In 1975 the poorest rural region had an infant mortality rate of 93 per 1,000 births, nearly three times the rate of 34 for Santiago. By 1986 the infant mortality rate in the poor rural area was 25 while the rate in Santiago was 15. The infant-mortality rate for all of Latin America was 48 in 1986. There was evidence of a significant decline in child malnutrition. It is relevant to note that substantial improvements occurred in health and nutrition after 1982 even though it was not until 1988 that GNP per capita had returned to the 1981 level and that the real costs of medical services were contained.

The reform of social security accomplished several objectives. It permitted individuals to opt out of the public system and purchase annuity contracts with private funds. Participation is compulsory, with the individual required to contribute 10 percent of salary for retirement and 3.4 percent for disability and survivor's pension. In 1980 the payment by both employees and employers ranged from 32.5 to 41 percent of payroll. Clearly the new private system cost much less than the one it replaced. It is projected that the retirement system will provide a retirement income approximately equal to final pay before retirement.

The reforms had three other major effects. First, decisions on pension levels was taken out of the wage-negotiating process; it was easy to make large promises about pensions that would not be paid for some years. Second, the creation of private financial agencies helped to create a fluid capital market. Third, the rate of return on the pension funds has been far higher than the 2 percent the old system returned. A minimum pension at 85 percent of the minimum wage is guaranteed for those who have participated in the old and new systems for 20 years. That is about 40 percent of the average wage.

The municipal reform was an effort to move the decisions concerning many public services to the governmental unit closest to the people who use the services. In Chile, as in most other Latin American countries, there was heavy control over local services from the capital city.

I cannot say that I read every word in the book, but I read most of them and enjoyed doing so. I did not find General Pinochet's name

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anywhere. There is an occasional reference to the military government but this is as close an identification of the governmental authority as one gets. General Pinochet was responsible for many very bad things; it seems to me appropriate that he be recognized for the good things that would not have happened except for him.

D. Gale Johnson
University of Chicago

The Economics of Prohibition

Mark Thornton
Salt Lake City: University of Utah Press, 1991, 153 pp.

Some of the strongest arguments against making drugs illegal come from economics. In arguing for legalizing drugs, I have often referred people to my article "A Humane Economist's Case for Drug Legalization" (Henderson 1991). But what has been needed is a *book* that pulls all these arguments together. The ideal book would, in a clear and compelling way, explain the economic effects of prohibition. (I use "prohibition" to refer to making any good illegal and "Prohibition" to refer to the Prohibition era early in this century.) Such a book would draw not just on recent evidence about illegal drugs, but also on the U.S. experience with Prohibition. The ideal book might also discuss the main economic literature on prohibition. *Undoing Drugs* by Daniel Benjamin and Roger Leroy Miller (1991) does some of this but not all; nor does it argue for legalization.

I had hoped that *The Economics of Prohibition*, by economist Mark Thornton, would be that ideal book. Almost all the elements are there: the economic analysis, the evidence from the Prohibition era, the discussion of the economics literature, and the case for making drugs legal. Unfortunately, one important element is missing. The book is badly written. The style is slow and boring; the reader often has trouble knowing where the author is going or even why some point is relevant; arguments and facts are presented incompletely.

Thornton shows how making a good illegal reduces the supply and therefore raises the price. One result, which is intended by prohibitionists, is that users of the good demand less of it. But Thornton, drawing on terminology from Austrian economist Israel Kirzner, points to four categories of unintended consequences of prohibition, all of which stem from interference with the free market's discovery process. Unfortunately, having laid out the four categories, Thornton does not do much with them.

On one unintended consequence of prohibition—drug potency—Thornton has a nice discussion. He shows, using standard economic analysis, that making drugs illegal causes the mix of drugs sold to be more potent. The idea, drawn from work by Armen Alchian and William Allen, and by Yoram Barzel, is that prohibition acts like a tax. If the

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government imposes the same per-unit tax on beer and whiskey, the price of beer, though still lower than the price of whiskey, becomes higher relative to the price of whiskey. Buyers would rationally respond by increasing the percentage of whiskey in the mix of liquors they buy. I communicate this subtle economic insight to noneconomists with the old saying: "You might as well be hanged for a sheep as for a lamb."

Thornton presents data from Clark Warburton, the main economist who made a sustained argument against prohibition towards the end of that era, showing that the price of beer did increase substantially relative to the price of whiskey. He also quotes prohibition advocate Irving Fisher's reference to the "well-known fact that prohibition has been more effective in suppressing the drinking of beer than of whiskey."

Unfortunately, the data that Thornton presents on potency during Prohibition are on the ratio of expenditures on beer to expenditures on spirits. But expenditure is not the same as quantity. It is price multiplied by quantity. What matters for Thornton's point is the ratio of the quantity of beer purchased to the quantity of spirits purchased. Yet he does not present data on the ratio of quantities for the Prohibition era. The closest he comes is to present a table of quantities of various alcohols consumed between 1840 and 1919. But because this whole period predated Prohibition, his data are useless for assessing his argument. Thornton does present data, though, showing that marijuana has become more potent as drug enforcement has increased.

Thornton also has an interesting discussion of the connection between crime and prohibition. He quotes the following statement from one modern author: "A major wave of crime appears to have begun as early as the mid 1920's [and] increased continually until 1933 . . . when it mysteriously reversed itself." Thornton points out that the crime wave coincided with Prohibition (1920-33) and that the reversal followed the end of Prohibition. He believes that this is no coincidence. His argument here is a little vague. He does not make clear *why* crime increased. Was it due to violations of the Prohibition law? Or was it for some other reason? Thornton argues, plausibly, that drug prohibition in recent years has raised drug prices so high that many buyers commit crimes to pay for drugs. He tells how crime increased in the 1960s, 1970s, and 1980s as enforcement of drug laws increased. But he never makes clear whether he is arguing that the same thing happened with alcohol during Prohibition.

Thornton also attributes much of government corruption to prohibition. He tells how corruption grew during Prohibition and cites similar evidence for the current drug prohibition. Thornton notes, for example, that federal convictions of corrupt public officials increased from 44 in 1970 to 1,067 in 1988 and cites a Department of Justice study that claims that 75 percent of state and local law-enforcement corruption is directly related to prohibition.

Thornton's material on the various interest groups aligned on either side of prohibition is also interesting. He tells how physicians and phar-

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macists united early in the century to end competition from alcohol and from the patent-drug industry. He then argues that marijuana's competitors would also have had an interest in campaigning to make marijuana illegal. Marijuana, claims Thornton, "has been one of the most important crops in human civilization." It has been used to make fiber, medicine, and oil. Thornton notes that E.I. du Pont de Nemours, which produced artificial fibers and petroleum-based drying oils, would have gained from the elimination of competition from marijuana. Yet Thornton never tells us whether Du Pont *did* lobby against marijuana.

Thornton's book contains much valuable information on prohibition and cites many sources. But the economically literate book on prohibition that makes a case for legalization has yet to be written.

David R. Henderson
Naval Postgraduate School
and the Hoover Institution

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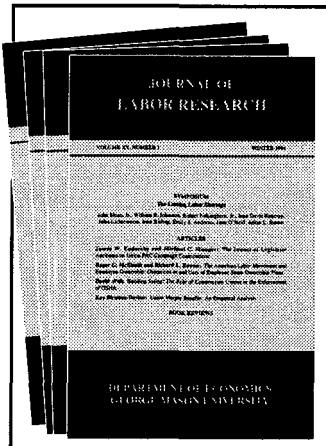

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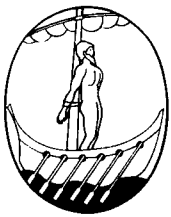

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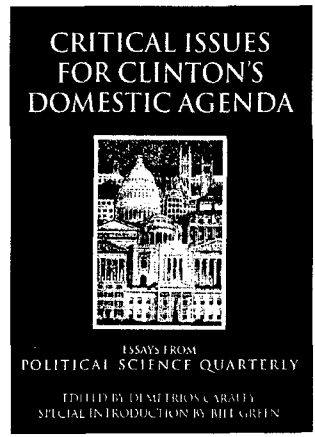

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